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FINAL REPORT AND RECOMMENDATIONS

REPORT

OF THE

HUD/MOD REHAB INVESTIGATION SUBCOMMITTEE

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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LETTER OF TRANSMITTAL

U.S. Senate,
HUD/Mod Rehab Investigation Subcommittee,
Washington, D.C., November, 1990

Hon. Donald W. Riegle, Jr., Chairman
Committee on Banking, Housing and Urban Affairs
U.S. Senate, Washington, D.C.

Dear Mr. Chairman: After eleven months of investigation and hearings, we are pleased to transmit our Final Report and Recommendations.

Respectfully submitted,

CHAIRMAN BOB GRAHAM

SENATOR CONNIE MACK

SENATOR RICHARD BRYAN

SENATOR RICHARD C. SHELBY

PREFACE

On November 21, 1989, the Senate created the HUD/Mod Rehab Investigation Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs to continue the investigation of the Committee into the management of the Section 8 Moderate Rehabilitation Program and related programs at the U.S. Department of Housing and Urban Development.

This report of the HUD/Mod Rehab Investigation Subcommittee is the culmination of that investigation.

The Subcommittee is composed of Senator Bob Graham (D. Florida), Chairman, Senator Connie Mack (R. Florida), Ranking Republican Member, and Senator Richard C. Shelby (D. Alabama), Senator Richard H. Bryan (D. Nevada), and Senator Christopher S. Bond (R. Missouri).

The Subcommittee held ten hearings, at which 78 witnesses testified, over the period from January to June 1990, covering the following subjects: The Mission of HUD; Subsidy Layering; Co-insurance; Low Income Tax Credits; The Federal Managers Financial Integrity Act; Staffing Issues; Executive Branch Oversight; Congressional Oversight; and Inspector General Reports.

In addition, Subcommittee staff conducted extensive informal interviews and read thousands of documents in preparation for hearings and this report.

These hearings permitted the Subcommittee to build upon the record established by the Senate Committee on Banking, Housing and Urban Affairs in its series of hearings held between May and October 1989. The Subcommittee also benefited from the extensive investigation conducted by the Subcommittee on Employment and Housing of the House Committee on Governmental Operations.

The Subcommittee is grateful to the witnesses and others who have contributed to its understanding of the problems at the Department and of possible solutions. In particular, the Subcommittee expresses its appreciation to Secretary Jack Kemp and Inspector General Paul Adams for their cooperation. The Subcommittee is also grateful for the assistance provided by Morton J. Schussheim, Senior Specialist in Housing, Congressional Research Service, whose report entitled "The Mission and Management of HUD" appears as an appendix to this report.

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PART ONE
EXECUTIVE SUMMARY

MISMANAGEMENT AND ABUSE AT THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

I. The Subcommittee Investigation

A. Background

On April 26, 1989, Inspector General Paul Adams released an audit of the Section 8 Moderate Rehabilitation Program administered by the U.S. Department of Housing and Urban Development (HUD).[1] The audit was similar to many other audits the Inspector General had written critical of programs at the agency over the preceding several years, but it was unique in its command of the attention of the nation. It revealed that a program designed to provide funding for low-income housing had become substantially abused by the politically well-connected. The report mentioned some prominent people as having received substantial amounts of money as consultants not because of their housing expertise, but because they could influence HUD funding decisions.

The Senate inquiry into the audit began on May 17, 1989 by the Senate Committee on Banking, Housing and Urban Affairs. The inquiry in the House began on May 8, 1989 by the Subcommittee on Employment and Housing of the Committee on Governmental Operations.[2] Over the course of the spring, summer, and fall of 1989, each committee held a number of hearings that revealed an alarming number of serious instances of fraud, abuse, and mismanagement at HUD.[3]

The Inspector General reports and the congressional investigations revealed that during the 1980s HUD became an agency that lacked the political leadership to properly carry out its established mission.[4] The scandals that characterized the Pierce Administration were the product of a confluence of factors. First, the hands-off management style of Secretary Pierce fostered a climate ripe for abuse. Second, programs suffered design flaws that made them susceptible to abuse. Third, as funding levels were reduced, competition increased for the dwindling funds.[5] Fourth, too many political appointees at HUD were either ill-prepared to serve at the agency or uncommitted to the programs, or both. Fifth, career staff were demoralized and lacked sufficient resources to properly administer, implement, and monitor programs.

HUD mismanaged programs either because it opposed the program itself, such as Mod Rehab, or because it lacked the capacity or leadership to operate them free from abuse. Unfortunately, the various parties responsible for oversight were all negligent, including HUD itself, OMB, and the Congress.

Secretary Kemp characterized the agency he inherited as being "from the structure of its programs to the management of its resources -- in a state of almost complete disaster and disarray."[6] Kemp took a number of swift actions to address many of these abuses, including cancelling and suspending programs and suspending program participants, actions he was alarmed had not taken place earlier.[7]

During the fall of 1989, the Kemp Administration presented Congress with a reform package aimed at the problems and abuses that had come to light. The Department of Housing and Urban Development Reform Act of 1989 addressed a number of problems revealed by the scandals, including subsidy layering, funding decisions, use of consultants, and monitoring.[8]

B. Creation of Subcommittee

While the Senate was considering the HUD Reform Act, the Senate Banking Committee continued its investigation into problems and abuses at HUD. To do so, the Senate adopted a resolution creating the HUD/Mod Rehab Investigation Subcommittee to focus on a number of topics that either had been inadequately addressed or needed to be further investigated to take into account of events that occurred subsequent to the Banking Committee's hearings.[9] Senator Bob Graham, who had been instrumental in the earlier full committee hearings was named chairman.

Chairman Bob Graham has often explained the Senate investigation of HUD in terms of the "rats" and the "cheese." The HUD scandals that have been the subject of intense media coverage and congressional investigation have for the most part focused on the rats. The scandals had been described in terms of the personalities: the hands-off management style of Samuel Pierce, the former HUD Secretary, his Executive Secretary, Deborah Gore Dean who lacked a housing background yet wielded substantial power by operating programs in a political manner, and high profile consultants, hired not because of their knowledge of housing but because of their access to decision-makers at HUD.

On January 30, 1990, at the first of ten Subcommittee hearings, Graham announced his intention to focus the inquiry upon the agency and its programs -- the "cheese" -- to learn what made them susceptible to abuse. Ranking Republican Connie Mack strongly supported this focus.

Graham also announced his intention to explore the role of the Executive Branch and Congress in their oversight of HUD so as to provide the Senate Banking Committee, as the authorizing committee, with information that would assist it in formulating policy and in conducting its continuing responsibilities over HUD and its programs.

II. Principal Findings

The investigation of the Subcommittee fell into three broad categories: program flaws, capacity, and oversight.

The Subcommittee finds that the programs examined had significant design flaws:

- The purpose of the Mod Rehab program was not adequately defined and evolved into a program that funded substantial rehabilitation.
- Funding criteria for the Mod Rehab program were not specified when Congress abolished the fair share requirement.
- The coinsurance program allowed the abdication of underwriting decisions to lenders without adequate safeguards and provided incentives to engage in poor underwriting practices.
- The low income tax credit was enacted without adequate consideration of its impact upon other subsidy mechanisms. Until the HUD Reform Act of 1989, no mechanism was in place to address subsidy layering and the avoidance of undue profits.

The programs also suffered from significant mismanagement. For example:

- HUD operated the Mod Rehab program between 1984 and 1988 totally at the discretion of the Secretary or his allocation committee without guidelines or documentation.
- HUD operated the Mod Rehab program in a political manner, making many funding decisions based upon the political affiliation of the developer or, in some cases, the consultant, thus allowing the program to become subject to favoritism and abuse.
- HUD inadequately monitored the underwriting practices of participating lenders in the co-insurance program, resulting in approximately $1 billion in losses.

Some have attributed the HUD's mismanagement to a lack of interest or concern for housing programs by top agency officials. William Diefenderfer, Deputy Director of OMB, put it this way:

> The conclusion I would come to is that they didn't pay any attention to those programs because they didn't care about the programs. They didn't go out of their way to make them run poorly or to make them run better.[10]

This seems most accurately to portray the problems with the Mod Rehab program, which the Pierce Administration sought to terminate. Faced with congressional continuation of a program it believed to be neither efficient nor effective, the Pierce Administration not only failed to administer it properly, but ran it in a manner that permitted favoritism and abuse. However, the HUD scandals were not merely the product of mismanagement, but of program design flaws and oversight failures as well.

Before launching into its investigation of HUD programs, however, the Subcommittee sought to place the scandals in context and to understand the true mission of the agency.

A. Mission of HUD

The Subcommittee's initial hearing invited former Secretaries and their top representatives to explore HUD's mission and the scandals. HUD's first Secretary, Robert Weaver, (1966-1968) shared with the Subcommittee HUD's initial mission, to provide "a decent home and a suitable environment for every American family."[11] This was followed by a quantifiable mission to provide 26 million units of housing within 12 years, including 6 million units for low and moderate income families.[12]

Over the years, the original mission has been re-adopted by Congress, including the 1990 housing legislation being considered by Congress.[13] However, the focus of the agency has changed over time as Congress and certain administrations have emphasized community development and housing programs have become more targeted toward lower-income persons. For example, Secretary Kemp has taken action to terminate or suspend two programs which have been plagued with loss and mismanagement for the very reason that they do not serve low-income persons, believing them to be inappropriate for the agency as he views its mission.[14] While housing needs in this country do not seem to require the quantitative goals set forth by Congress in 1968, the recent problems at HUD do provide HUD and Congress with an opportunity to re-evaluate the proper role and mission of HUD.

At the time of this report, Congress enacted housing legislation which reiterates the original mission of HUD, but demonstrates differences between the Congress and the Executive Branch regarding the direction of the agency. The Kemp Administration favors programs aimed at the very poorest, programs aimed at providing opportunities for home ownership, and the use of certificates and vouchers over funding for new construction. The Subcommittee heard testimony from the General Accounting Office (GAO) which supports the view that, at least in soft markets, the use of certificates and vouchers can help far more families.[15] The Senate had expressed a preference for providing greater flexibility to state and local agencies in determining how best to meet local housing needs with federal assistance allocated by formula and with HUD providing policy direction and oversight. The House had favored a more traditional role for HUD.

The debate over the focus of housing programs is intertwined with the HUD scandals. Certainly, in areas having high vacancy rates, the provision of direct rental assistance makes considerable sense. Direct rental assistance is also less susceptible than other approaches to abuse by third parties.[16] But there is still a need for production programs.[17] The Subcommittee believes that flexibility is necessary to adapt to the particular needs of a given community. However, the Subcommittee also finds that care must be taken in the design and implementation of any program that relies upon the private sector. The programs examined suffered losses in part because incentives were provided that fostered abuse and because HUD failed to carefully monitor private sector activities. Many of these issues came to light in the series of hearings devoted to the cheese, beginning with the Subcommittee's second hearing on subsidy layering.

B. Subsidy Layering

The Subcommittee turned its attention to the "cheese": subsidy mechanisms that were the subject of substantial fraud or waste. The Subcommittee explored the subject of subsidy layering from the viewpoint of the developer. Among the issues the Subcommittee sought to explore was the level of assistance required to induce developers into providing low-income housing. We wanted to answer the question, "how much subsidy is enough?"

After analyzing the need for developers of low income housing to secure funding from multiple sources, the Subcommittee concluded that it would be inappropriate and perhaps impossible for HUD or Congress to determine a reasonable rate of return or profit level for developers. Too many factors enter into the financing of a particular project to permit the selection of what would be an arbitrary figure. Congress did, however, attempt to address the issue raised by instances where developers took windfall profits from the layering of subsidy without regard to necessity, by enacting provisions in the HUD Reform Act of 1989 and the Omnibus Budget Reconciliation Act of 1989 which require HUD and the state housing finance agencies, respectively, to consider other financing for a project when awarding subsidies or low income housing tax credits.[18] However, those provisions have created a "chicken and egg" problem: it is not clear from the operation of these two acts whether HUD, in providing subsidies, or state housing finance agencies, in awarding tax credits, will make the final determination of need based upon the amount of other available subsidies.

If the new provisions can be properly implemented, it may be that the opportunities for abuse in this area will be significantly lessened. Nonetheless, the situation is not yet resolved and will bear close monitoring by HUD, state housing finance agencies, and Congress.

Most alarming, however, is that the 1989 acts highlight an absence of coordination of housing and tax policies.

C. Moderate Rehabilitation Program

The Section 8 Moderate Rehabilitation Program was created in 1978 to upgrade substandard rental housing and provide rental subsidies for low income families. The Mod Rehab program has been described in its design as "delightfully simple,"[19] but its complexity grew when combined with co-insurance and other subsidy programs and mechanisms.

Congress refused to terminate the Mod Rehab program even though Pierce advocated its termination, finding it ineffective and inefficient. Instead, Congress continued to fund the program during the 1980s, though at reduced levels. According to the Inspector General and Pierce, however, Congress failed to fund staffing for the program.

Congress funded the program subject to a fair share requirement, whereby funds were initially made available to PHAs on a geographic basis before other eligibility criteria were applied. In 1984, Congress abolished the fair share requirement as funding for the program fell below an amount necessary to support it. However, Congress failed to specify whether funding criteria for the program must continue and HUD took the position that they did not.

As the result, Pierce decided that funding under the program was completely discretionary. He saw no need for additional regulations, nor believed he had the staff to re-allocate to the program. The consequence was that for the period 1984-1988, the program was mismanaged and funding decisions were made without objective criteria. Pierce established a funding selection committee to recommend funding under the program.[20] However, in the absence of a rating system imposed by either Congress or HUD until 1988, the program was administered in a manner that became developer-driven and subject to favoritism and abuse.

Even though Pierce was aware of claims that the Substantial Rehabilitation program had become abused by consultants, he allowed the Mod Rehab program to be operated in a manner that also encouraged developers seeking funds to use consultants having political and other ties to HUD management. As a result, in too many instances the intent of Congress that the program be operated in a manner that provided funding to PHAs to meet local housing needs was ignored, and the program developed into one in which consultants could obtain units for developers even before the PHA knew to apply.

Without limits established by Congress or HUD and in the absence of any other rehabilitation program, the program changed from its original design. Funding per unit under the program grew rapidly. No longer a program designed for "moderate" rehabilitation, the program supported per unit costs that averaged $26,352 during the audit period 1984-1988 and reached as high as $80,000, according to the Inspector General. Problems with the program were exacerbated when projects were coinsured under the Multifamily Coinsurance program. Since co-insurers were empowered to determine contract rents and the mortgage amount, which were often set too high, excessive Mod Rehab payments were paid as well. Abuses also occurred when projects eligible for Mod Rehab funds also became eligible for low income housing tax credits.

Most of the abuses in the implementation of the Mod Rehab program were corrected by the HUD Reform Act of 1989 and administrative actions taken by Secretary Kemp. However, the nature of the program design flaws underscores the need for care by Congress and HUD in the creation of new programs or in any substantial change to an existing program.

D. Co-insurance

The Subcommittee held a roundtable discussion on the subject of multifamily co-insurance in light of several significant developments that had occurred since it was last explored by the Banking Committee.

Congress first authorized co-insurance in 1974, but it was not until 1983 that the first of three co-insurance programs was implemented by HUD.[21] The Co-insurance programs were poorly conceived and ineffectively administered. As a result, HUD/FHA has had to establish loss reserves of $960 million and GNMA has established loss reserves of $50.5 million to cover losses expected from defaults under the programs.

The Subcommittee found a number of design flaws in the co-insurance programs. These included the failure to establish and enforce adequate controls over the quality of loans funded through securitization with GNMA guarantee assistance. This resulted in poorly underwritten loans that exposed the Federal Government to risk far beyond that originally intended by Congress. By providing inadequate capitalization requirements and by allowing substantial loan origination fees tied to the amount of the mortgage but not requiring loan servicing fees, the program also created strong incentives for participating lenders to focus upon the production of high volumes of loans rather than upon loan quality, thus exposing the Federal Government to a high risk of loss. The program also suffered from an unacceptable concentration of risk in a few lenders, which should have been anticipated and could have been avoided through the establishment of leverage limitations. Other design flaws included the failure to provide a broad scope of remedies to deal with defaults under the programs.

There were implementation failures as well. These included the failure of HUD to properly monitor the underwriting practices of participating lenders and the failure to exercise available remedies against non-complying lenders.

HUD implemented the co-insurance programs partly out of a desire to privatize governmental functions and partly out of a recognition of the fact that HUD lacked the capability to continue to administer a full insurance program. The latter factor is of particular importance because, even though the co-insurance program contained serious design and implementation flaws, the termination of the co-insurance program does not address one of the original causes for its implementation: inadequate staffing. As HUD moves toward implementation of its version of full insurance it needs to carefully assess its current capacity to fulfill its new responsibilities.

In addition, since the integrity of the co-insurance program, as with any similar activity by a financial institution, is intimately related to the quality of the loans and underwriting practices, it is critical that there be clear statutory or regulatory guidelines for writing and monitoring loans.

E. Low Income Housing Tax Credit

The Subcommittee next addressed the low income housing tax credit, conducting another roundtable discussion of a variety of issues. The low income housing tax credit has become the principal Federal mechanism for the production of low income housing. As such, its continued use is vital to meeting the housing needs of persons in those areas of the country experiencing housing shortages. Nonetheless, the tax credit received only partial year funding for 1990 and was extended only until December 31, 1990.

In separate legislation last year, Congress addressed the issue of subsidy layering by increasing the role and responsibility of the state housing credit agencies in allocating credits. It also mandated that HUD and the Farmers Home Administration take account of the credit and other forms of assistance when providing assistance within their respective authority for housing projects. After reviewing these legislative provisions, the Subcommittee found a number of issues requiring resolution.

One is the "chicken and egg" dilemma described under the topic "Subsidy Layering." Under the HUD Reform Act, HUD must soon decide whether to attempt to implement new rules which may jeopardize the issuance of tax credits this year.

The Subcommittee is also concerned about the short term extension of the tax credit last year and its effect upon the viability of the credit as an important source of funds for the production of low income housing. Among the concerns of the Subcommittee is that housing credit agencies must develop the capacity to administer the credit program adequately, especially if they are given additional responsibilities recommended by the Subcommittee. To encourage that development, the tax credit must be given a more permanent or predictable status.

The roles of the state credit agencies and the Internal Revenue Service need to be clarified. While responsibility for the allocation of the tax credit is clearly placed in the housing credit agencies, they have not been given clear responsibility for monitoring the compliance of developers with the tax credit program's terms. Nor has any agency been given clear responsibility for determining the low income tax credit's success at meeting the needs of low income persons. The Internal Revenue Service has neither the expertise nor the capacity to undertake these responsibilities, and HUD cannot provide monitoring because it lacks responsibility for the actual allocation of credits to developers.

The Subcommittee found that the tax credit is not always a particularly efficient use of federal funds, especially in a soft housing market where the same amount of funds in certificates and vouchers can assist far more families. Furthermore, a significant amount of tax credit dollars can be lost during the syndication process, thus limiting its real effect in providing housing. Nonetheless, as the principal method of producing low income housing, the tax credit should be retained.

F. HUD Management

The second area of inquiry was management and staffing problems at HUD. The Subcommittee first investigated the manner in which the Pierce Administration addressed its responsibilities to uncover material weaknesses in its internal controls and financial management systems. It is not enough for HUD to rely upon the Inspector General to point out problems. Management must make itself aware of the problems and take corrective action.

Increasing fraud or waste in any government agency is usually a sign of poor management controls. Thus it was no surprise that the Subcommittee's look into past management efforts at HUD revealed serious internal control problems which have been lingering at the agency for years. But the Subcommittee also found that these problems have persisted in part because top officials of the previous administration failed to identify and address these problems, even when such problems were brought to their attention.

Perhaps the most troubling example occurred in 1987, when HUD reported to the President and to Congress that the agency's financial management controls were adequate. At the same time, HUD management knew that serious problems existed with HUD's accounting systems, such as the fact that the FHA fund's accounting systems did not comply with generally accepted accounting standards and the fund had been for the past 15 years deemed unauditable by the General Accounting Office.

Throughout the period between 1983 and 1988, the Inspector General monitored HUD management's efforts to identify and correct internal control problems. In addition to revealing that HUD management was conducting inadequate control reviews, the IG uncovered management problems that some HUD Assistant Secretaries refused to identify. These problems included, among other things, serious control deficiencies within HUD Coinsurance and the Section 8 Moderate Rehabilitation program. In many instances, only through much heated debate did the Inspector General persuade HUD management to identify most of these problems in an annual report to Congress and the President regarding the state of HUD internal management controls.

Today, the new HUD management has taken its job seriously, but longstanding internal control problems still plague HUD programs. Most prominent is the poor shape of HUD's financial systems, which cause management decisions to be made on the basis of outdated or incorrect financial information. In fact, GAO has revealed that inadequate financial controls are not unique to HUD. Astonishingly, GAO cannot point to a single federal agency that can be considered a model of good management controls.

G. HUD Staffing

The Subcommittee was also concerned about the capacity of HUD to perform its mission. One of the key causes of problems at HUD was the combination of administrators with dubious interest and knowledge of housing, severe staffing cuts, and a "brain drain" caused in part by lowered morale at the agency. The consequence of this: HUD was incapable of performing many services in an efficient manner or from ensuring that programs were adequately monitored for fraud and abuse.[22]

Past internal and external studies of HUD staffing have revealed that HUD has suffered from inadequate staffing levels, training, and travel expenses to adequately perform its responsibilities. The inability of HUD to monitor certain programs was an important cause of many problems at HUD and of the agency's inability to detect and correct those problems.

Under Secretary DelliBovi told the Subcommittee that HUD is currently more concerned about "outputs," the ability of HUD to produce desired results, than with "inputs," including staffing levels. While the Subcommittee agrees with the greater importance of outputs and has expressed repeatedly its desire to formulate output measures, it is nonetheless concerned that staffing issues must be a substantial part of the agency's examination of its programs.

Examples of critical staffing shortages continue to appear in the semi-annual reports of the Inspector General, as he has recently noted that HUD must use the same overworked staff to handle the co-insurance program and the Retirement Service Center Program.

H. Executive Branch Oversight

The Subcommittee then turned its attention to oversight, dealing first with the role of the Office of Presidential Personnel in the selection of persons for appointment to HUD and, more importantly, the role of the Office of Management and Budget in its oversight of HUD.

While HUD managers are responsible for guiding the day to day operations of the agency, the Office of Management and Budget is responsible for overseeing and coordinating management efforts of HUD and all other federal agencies. During the administration of Secretary Pierce, however, OMB oversight of HUD was, in the words of the current Deputy Director, essentially "moribund."

Ironically, OMB's management staff under the previous administration did indeed initiate an ambitious attempt to improve certain managerial objectives -- such as cost controls -- generally throughout the federal government. This effort, referred to as Reform 88, represented the most sustained management oversight effort of that agency since its reorganization from the Bureau of the Budget to OMB in 1970. However, like all past management efforts of OMB, those efforts waned due to a lack of sustained commitment and the overpowering demand for resources by OMB's budget staff.

OMB has been unable in its history to effect sustained management strategies free from budget-driven biases. Some former BOB and OMB officials have called for a total separation of management functions from budgetary functions, possibly by creating a separate Office of Management within the executive branch. Others maintain that a physical separation would not change management effectiveness, but that what is needed is an attitudinal commitment that management is in fact as high a priority as the budget. While OMB currently opposes this idea -- an idea that has survived since the days of Eisenhower -- those who advocate a separate management agency believe it may be the only way to ensure adequate executive oversight of the management of HUD and other agencies.

I. Congressional Oversight

The last hearing in this series involved the issue of Congressional oversight. The Subcommittee was concerned that Congress somehow failed to respond to a number of signals that serious problems existed at HUD throughout the Pierce Administration. The Subcommittee invited both the current and the original Inspector General at HUD, whose terms covered the Pierce years, to discuss the warnings they gave to Congress and their relationship with Congress. Former Inspector General Charles Dempsey was displeased with Congressional reaction to his semi-annual reports warning of problems at HUD, testifying that he "never received as much as a phone call."[23]

Senator William Proxmire, former chairman of the Senate Banking Committee and of the Senate Appropriations Subcommittee responsible for HUD during part of the Pierce administration, was equally contrite in stating that his committees "had no idea [the fraud and waste at HUD] was going on." Proxmire believed that Congress, along with the Secretary, OMB, and the press, were simply ignoring the reports of the Inspector General.[24]

While the Subcommittee found that the warnings given by the Inspector General were available to Congress, it also found that those warnings were not as clear as they might have been. At times the reports of the Inspector General were couched in terms that would lead the reader into the false belief that HUD management was heeding the warnings and taking appropriate corrective action. Recent improvements have been made in the reports to address this concern.

But the Subcommittee also found that the Inspector General made little attempt to bring his concerns to the Congress other than submit his reports and audits. For example, the Subcommittee explored the HUD Inspector General's failure to use a procedure by which he is to notify the head of the agency and through that head, the Congress, of flagrant abuses at the agency. Known as the "seven day letter," this device was created by Congress presumably to assist the agency in correcting serious problems and to assist Congress in its oversight responsibilities. The Subcommittee found that Inspectors General do not understand the intended use of this device and generally are reluctant to use what was characterized as the "hole card" of the Inspectors General.

The Subcommittee learned that Congress tends to concentrate upon the development of new policies and programs, often at the expense of caring about the degree to which existing programs are effectively and efficiently meeting congressional goals. Oversight is tedious, time-consuming, and far more likely to be politically rewarding if it is in reaction to an exposed crisis. Thus "fire alarm" oversight tends to predominate over the more mundane "police patrol" oversight. Congress must use the tools it creates to apprise it of problems within an agency. Congress can do so by putting in place a mechanism whereby, at a minimum, it carefully monitors the semi-annual reports of the Inspector General and the annual Federal Managers Financial Integrity Act report.

The final hearing of the Subcommittee provided the Inspector General with the opportunity to present his latest semi-annual report to a Congressional committee. Such a hearing represents de-minimis oversight in that it focuses Congressional attention on the most current problems and provides a forum for further inquiry if warranted. The Subcommittee also received the Secretary's semi-annual report. Under Secretary DelliBovi was thus provided the opportunity to react to the Inspector General's criticisms and to acquaint Congress with the latest developments at the agency, including actions taken to correct past problems.

The Subcommittee also turned its attention to the need for the development of data and goals that can facilitate the measurement of the effectiveness of HUD in carrying out Congressional intent regarding housing programs. One of the problems that has plagued the agency is its inability to provide its managers, much less Congress, with basic information critical to an evaluation of effectiveness. DelliBovi told the Subcommittee that HUD is undertaking a thorough review of its programs and will develop indicators by which it can measure "outputs."[25]

Congress needs to be involved in that analysis to ensure that the indicators developed and the data collected to support those indicators are consistent with Congressional intent and the furtherance of Congress' oversight responsibilities.

The Subcommittee also addressed the additional responsibility of the Senate with respect to the confirmation of nominees to administrative positions at HUD. Many witnesses have testified that among the problems at HUD during the 1980s was that top administrators either lacked knowledge or interest in housing. HUD was said to have become a dumping ground, led by a Secretary who had a self-described "hands off" management style that helped create an environment that either permitted or encouraged the types of mismanagement and abuse described in this report. Congress tends to provide the President great latitude in the selection of his team to administer agencies in the Executive Branch. It is rare indeed when a nominee is rejected. During the 1980s, Deborah Dean was one of only two persons nominated to a position at HUD who failed to gain confirmation.[26]

One of the problems the Senate faces is that it often lacks information regarding the qualifications of the nominee. Given the problems that HUD has encountered in the past, it may behoove the Senate to explore methods by which it can obtain the advise of an outside group which can evaluate the nominee and provide its recommendation to the Banking Committee.

Finally, regarding oversight in general, if there is one lesson for Congress to learn from the HUD and other scandals during the 1980s, it is this: when programs have either high or low priority, Congress and affected agencies must enhance their vigilance. Popular programs, such as defense programs, invite and permit abuse simply because no one wishes to stop the juggernaut.

Similarly, when priority for programs is low, such as housing programs during the 1980s, there exists the likelihood that they will be administered by persons who are less qualified or more uninterested than in other agencies. Staffing and funding level cuts will allow abuses to occur and go undetected and agencies charged with oversight will be giving their limited attention to more popular programs. This is also especially true with respect to programs Congress chooses to continue over the objection of the agency. Both HUD and Congress must be mindful of this lesson as they both act in their respective roles to ensure that the mission of HUD is implemented.

III. Recommendations

The Subcommittee believes that the HUD Reform Act carefully addressed the HUD scandals, and attention must now be paid to its implementation. In addition, a number of actions should be taken to address remaining problems.

Programmatic Issues

A. Program Design

(1) *Congress must formulate programs in a manner which simplify administration and eliminate opportunities and incentives for abuse, especially in programs which involve the private sector in their implementation.*

(2) *Congress should formulate goals and performance measures for federal programs when created or authorized. Each federal agency should develop goals and performance measures for their programs and submit a plan for their accomplishment with the agency budget request submitted to OMB. In addition, Congress and the federal agencies should determine data to be collected to support those indicators, to ensure the goals and indicators are consistent with congressional intent and that the data collected will facilitate the congressional oversight responsibilities.*

B. Subsidy Layering

(1) *Congress must improve coordination between Federal tax policy and housing programs.*

(2) *Federal housing programs should be adequately and consistently funded and consistently designed to facilitate planning and management.*

(3) *Federal subsidies should be flexible and allow room for negotiation.*

(4) ***HUD should ensure that projects are not oversubsidized through improved oversight and monitoring of subsidy programs.***

C. Fair Market Rents

(1) ***HUD should conduct a comprehensive study which assesses the accuracy of the Fair Market Rents relative to actual market rents. The results of this study should be submitted to the Congress.***

(2) ***HUD should explore alternative methods for incorporating more market-sensitive data into the Fair Market Rent calculation -- particularly in those non-metropolitan and rural areas not covered by the American Housing Survey or Consumer Price Index surveys. In so doing, HUD should proactively solicit comments from PHAs and Area Offices on the accuracy of Fair Market Rents.***

D. Co-insurance

(1) ***HUD should give high priority to the mitigation of losses that may be realized from the co-insurance programs.***

(a) The Department should take all possible action to reduce such losses, so long as they are economically advantageous, including consenting to the modification of co-insured loans or providing insurance of refinanced loans, operating loss loans, or supplemental loans, where the additional extension of credit is appropriate to facilitate the cure or work-out of a co-insured loan in default.

(b) HUD should make every effort to minimize the interest cost that the Federal Government ultimately will absorb with respect to co-insured loans that default, so long as these efforts are economically advantageous.

(c) HUD should report to the Congress within 60 days of the Subcommittee's Report the conditions under which the Department would approve the conversion to fully-insured status of co-insurance portfolios not yet controlled by GNMA.

(d) HUD should review whether Bankruptcy Code amendments such as those recommended by the Mortgage Bankers Association are necessary to protect insured lenders' security interests in project cash receipts and to prevent delays in project foreclosures due to bankruptcy filings of borrowers that have no reasonable prospect of reorganization in bankruptcy. The Department should make legislative recommendations expeditiously following such review.

(e) HUD should determine whether to recommend to the Congress that the Multifamily Mortgage Foreclosure Act be amended to apply to co-insuring lenders as well as to HUD/FHA. In addition, HUD/FHA should participate aggressively in the loan foreclosure process with the object of accelerating the completion of that process.

(f) HUD should take immediate action to improve its systems of monitoring the insurance risk that HUD/FHA has assumed and continues to assume under the co-insurance programs. These improvements should include those recommended by Price Waterhouse in its January 18, 1990 Report to the Department on the co-insurance programs.

(2) ***Prior to undertaking to underwrite multifamily project loans on a full insurance basis in lieu of co-insurance, HUD should adequately address the design and implementation flaws that resulted in substantial losses under the co-insurance program.***

(a) The Department should identify and obtain the human and other resources necessary to carry out such underwriting in a prudent, safe and sound manner.

(b) The Department should adequately remove the material weaknesses in HUD/FHA's internal controls and financial management systems that materially impair the capacity of HUD/FHA to perform multifamily mortgage insurance underwriting.

(c) The Department should focus on insurance underwriting in selected real estate lending markets that are geographically and by loan program well known to HUD/FHA.

(d) The Department should make every effort to establish program requirements that are sufficiently rigorous to minimize the Federal Government's insurance risk.

(e) The Department should provide for risk sharing between HUD/FHA and the insured lender within the discretion permitted by the National Housing Act without exercise of the co-insurance authority of Section 244 of the Act (which HUD/FHA would not mean to exercise with a full insurance program.)

(f) The Department should anticipate the need for, organize, and obtain the resources necessary to implement program monitoring that will enable HUD/FHA on a continuing basis to know its risk of loss and to respond quickly to loan defaults.

(g) The Department should define clear program objectives relating to both housing goals and insurance underwriting objectives and specific criteria by which HUD/FHA and the Congress can measure the success of HUD/FHA in achieving the objectives.

(h) The Congress should amend the statutory provisions relating to the FHA's general insurance fund to clarify the actuarial standard or standards that are to govern HUD/FHA's management of such fund and the mortgage insurance programs that are funded from it.

(3) ***HUD should give careful, further consideration of how it could successfully implement the co-insurance authority of Section 244 of the National Housing Act with respect to multifamily project loans. If the Department determines that the conditions to successful exercise of this authority require further statutory definition beyond the amendments effected by the HUD Reform Act of 1989, it should submit its legislative recommendations to the Senate Banking Committee within 60 days of the Subcommittee's Report.***

(4) ***The General Accounting Office should review the audited financial statements HUD prepared for the FHA insurance funds as of September 30, 1989, and report to the Senate Banking Committee any material comments that it has on such statements, particularly any comments comparing accounting judgments in such statements with those in the September 30, 1988, financial statements prepared by GAO.***

(5) ***GNMA should provide to the Senate Banking Committee within 60 days of the HUD/Mod Rehab Investigation Subcommittee's Report a written explanation of the reasons for its original election to retain, and its continued reliance upon, York Associates, Inc. to service the co-insured portfolio that GNMA took over from DRG Funding Corp. GNMA's report should also explain when GNMA was first able to terminate York as an issuer and why termination of York did not occur earlier.***

E. Low Income Housing Tax Credits

(1) ***The Congress should take account of the effect of one year extensions of the tax credit authority upon the capacity of housing credit agencies to administer the tax credit program and should grant an extension that is not less than three years.***

(2) ***HUD must implement Section 102 of the HUD Reform Act in a manner that is well coordinated with the actions of the housing credit agencies in order to facilitate expeditious allocations of tax credits by the housing credit agencies and achieve the objectives of the Act and the 1989 amendments to Section 42 of the Internal Revenue Code.***

(a) The Department must integrate into its Section 102 procedures requirements for timely action by the Department.

(b) If HUD is unable to implement timely its administrative instructions regarding the combination of HUD assistance with tax credits, then the Department should defer making such instructions effective until 1991.

(3) ***The Congress should clarify and expand the responsibilities of the housing credit agencies in the administration of the credit program.***

(a) The Congress should clarify and expand the responsibility of housing credit agencies for monitoring credit-assisted developers' compliance with the credit program's requirements. If the role of the credit agencies is expanded, their ability to delegate any of their new responsibility to local public housing authorities or other local agencies should be made clear. Credit agencies, also, should make every effort to control the costs of any expanded monitoring program.

(b) The Congress should clarify the responsibility of housing credit agencies for evaluating annually data regarding the implementation of the tax credit program. The Congress should require the credit agencies to report the results of their evaluations to the Congress through the Secretary of the Treasury. The Secretary should be a conduit only and not impose evaluation requirements upon the credit agencies.

(c) In connection with the proposed expanded role of the housing credit agencies in the evaluation of program implementation data, the credit agencies should monitor and evaluate their success in using the credit program efficiently to address acute housing needs, including those of families eligible for occupancy of public housing units.

(4) ***The Congress should take further actions to ensure that project owners do not receive excessive subsidies in combination with the tax credit.***

(a) The Congress should monitor closely whether and how the housing credit agencies control the use of project cash receipts from Section 8 rental assistance payments and other subsidy sources that (1) the credit agencies do not take account of in determining the credit allocation to a project and (2) HUD or the Farmers Home Administration is not obligated to reduce in light of other assistance pursuant to the requirements of the HUD Reform Act.

(b) The Congress should establish the manner of determining the fee that may be paid to a credit-assisted project developer from project funds. If such statutory provision establishes a limit on the fee, it should permit the state credit agencies the flexibility to establish a more stringent limit.

(5) ***Upon its completion of its multi-year study of the tax credit program, HUD should submit its study report to the Banking and tax writing committees of the Congress.***

Capacity Issues

A. HUD Management

(1) ***All Inspector General and GAO audits of any federal agency should state in the summary whether problems discussed by the audit are considered, in the opinion of the auditor, "material weaknesses" pursuant to the Federal Managers Financial Integrity Act (FMFIA).***

(2) ***All inspectors general should be required to investigate any meaningful allegations that agency managers may have lied or made misrepresentations in their FMFIA evaluations or in the subsequent final report. All inspectors general should be required to report on their findings within 60 days after a formal allegation is made to them in writing.***

(3) ***All agencies should be required to estimate in their annual budgets the resources needed to evaluate programs and correct weaknesses. In addition, OMB should monitor agency corrective actions to determine whether such actions are effectively addressing the problems. OMB's budget should reflect the management-side resources needed to perform such monitoring.***

(4) ***The relevant congressional committee should be required to hold a hearing each year on the FMFIA report corresponding to each agency under its jurisdiction.***

B. Staffing

(1) ***HUD should conduct its new capacity study and reporting requirements concurrently with its in-depth review of its housing programs.***

(2) ***HUD should undertake a study of the level of political appointees at the agency and the positions filled by those appointees, especially at the Deputy Assistant Secretary level, to determine if the level is justified and report to Congress its evaluation and recommendations regarding those positions that might be better filled by career staff.***

(3) **(Majority Recommendation)** ***The position of Assistant Secretary for Administration at HUD should be converted to a permanent, career-SE position.***

Oversight Issues

A. Executive Branch Oversight (Majority Recommendations)

(1) ***The Office of Management and Budget should be split into an Office of Budget and a separate Office of Management.***

(2) ***The Program Associate Director positions at the Office of Management and Budget should be made career positions.***

B. Congressional Oversight

(1) ***The Senate Banking Committee and its Subcommittee on Housing and Urban Affairs should enhance their oversight of HUD and its programs.***

(a) The Committee or Subcommittee should hold hearings to receive each Semiannual Report of the HUD Inspector General, each Semiannual Report of the HUD Secretary, and the department's annual FMFIA report.

(b) The Committee or Subcommittee should undertake an analysis of the mission of HUD as part of a monitoring HUD's announced intention to completely review its programs, to determine the role HUD should play in meeting the housing needs of this country.

(c) The Committee should designate a staff person responsible, on a full-time basis, for developing an oversight plan for the committee, collecting and analyzing GAO, IG and agency reports, especially FMFIA, and issuing oversight reports and conducting follow-up on those reports. In addition, this person would act as a liaison with the IG and GAO concerning these reports and any other matters important to call to the attention of the Committee. At the very least the Subcommittee on Housing and Urban Affairs should designate a staff person to perform such duties with respect to HUD.

(d) Congressional oversight ought to be considered at the policy-making stage as a principal means of avoiding foreseeable breakdowns in programs and management.

(e) Prior to enactment of any new program or substantial change in an existing program, HUD should prepare a "housing impact statement." This statement would identify the effect that the Congressional proposal would have on existing and future HUD staffing and management resources and on existing HUD programs.

(2) **(Majority Recommendation)** ***The Senate Banking Committee should establish an ad hoc advisory board to provide confidential recommendations to the Committee members regarding the qualifications of persons seeking confirmation for appointment to positions at the Department of Housing and Urban Development. The board would provide a similar service to that provided by the American Bar Association in its review of federal judiciary nominees. Although care would obviously have to be taken in appointing Board members in order to avoid direct conflicts of interest, those who would be appointed to this Board would be acknowledged housing specialists and academicians familiar both with the department and housing programs and the administration thereof.***

(3) ***The Senate should review its rules relating to oversight by the various committees to determine the appropriate level of commitment to oversight responsibilities.***

(a) The Senate should reconsider a requirement that certain committees establish a separate oversight subcommittee or require their subcommittees to engage in oversight activities. In the alternative, the Senate Banking Committee should consider such changes in its rules.

(b) The Senate should reconsider a change in its rules to require its committees to prepare a two-year oversight plan and provide a copy to the Senate Committee on Government Affairs in advance of each new Congress.

(4) ***The Inspector General Act should be amended to require the Secretary's Semiannual Report to reflect the goals for each program under HUD and the measure of the effectiveness with which HUD has attained those goals during the reporting period, together with an assessment of actions to be undertaken to achieve those goals.***

(5) ***The Inspector General Act should be amended to clarify Congressional intent regarding the use of the seven-day letter.***

ENDNOTES

1. "Thomas T. Demery, Section 8 Moderate Rehabilitation Program," Report of Investigation, Office of Inspector General, No. HM 1-1054, April 17, 1989.

2. At the time this report was being prepared, the official transcript of the hearings of the House Subcommittee on Employment and Housing was unavailable for hearings held after June 16, 1989. Accordingly, where necessary, reference to the transcript of any subsequent hearing of that subcommittee is made to the unofficial transcript made available to the Subcommittee by the House subcommittee.

3. Chapter 2 of Part Four of this report provides a brief description of the various hearings held by the Subcommittee, the Senate Committee on Banking, Housing and Urban Affairs, and the House Committee on Government Operations, Subcommittee on Employment and Housing. For a more detailed discussion of the principal HUD scandals, see Part Three of this report. The abuses discussed in this report are not the first scandal at HUD. Since its creation in 1965, HUD has been a troubled agency, responsible for many programs that have tempted builders, lenders, HUD employees, and recipients of housing to engage in fraud and other illegal or unethical behavior. It has been the subject of scandal, the heretofore most noteworthy of which occurred in the 1950's involving FHA. Kaiser, F., "Past Program Breakdowns in HUD-FHA: Section 608 Multifamily Rental Insurance Program of the 1940s," Congressional Research Service, March 19, 1990. Nearly every administration has been touched by scandal at HUD, though none of the type and level that is the subject of this report. Former HUD Inspector General Charles Dempsey summarized many of the scandals and problems that have plagued the agency under virtually every administration. Dempsey, C., "Formula for Scandal," Government Executive, October 1989.

4. After reviewing previous HUD scandals, former HUD Inspector Charles Dempsey offered the following assessment of why during the 1980s, the wrong combination of circumstances befell HUD and led to the abuses that are the subject of this report:

> With its many complex programs and tough goals, HUD demands strong hands-on leadership and management, a capable and experienced staff to operate its affairs, and congressional oversight.
>
> Enter the Reagan Administration.

Dempsey, "Formula for Scandal," Government Executive, October 1989 at p. 48.

5. There are a number of measures of the impact of the 1980s upon housing assistance. During that period, the Administration requested substantial reductions in budget authority, and it was slashed from $35 billion in 1981 to $9 billion in 1989. These cuts reflect four factors: A sharp reduction in the number of newly assisted households (e.g., down from 375,000 to 75,000 between 1977 and 1983), the shift toward cheaper existing-housing assistance, a systematic reduction in the term of new commitments, and since 1987, a change in the method of financing construction and modernization of public housing. Nonetheless, the total number of families receiving assistance rose from 4.1 million in 1981 to 5.4 million in 1989. This increase is

attributable to a combination of net new commitments during the period and prior commitments that were processed during this period. Also, despite reductions in budget authority, actual outlays for housing rose from $7.9 billion in 1981 to 17.3 billion in 1989. This is attributable to a number of factors, including a rise in the number of households occupying units constructed under the Section 8 new construction program, a reduction in the share of households receiving less costly home ownership assistance, a change in focus of assistance toward poorer families, and the fact that assisted rents rose faster than the income of assisted families. Congressional Budget Office at pp. 1306-1314.

6. Jack Kemp, Secretary of HUD, Testimony, Hearings, Vol. 2, May 16, 1990 at p. 587.

7. Chapter 2 of Part IV of this report reviews a number of actions Kemp has taken at HUD in response to the programmatic flaws and management failures of his predecessor.

8. Chapter 3 of Part Four of this report provides a summary of the major provisions of the Department of Housing and Urban Development Reform Act of 1989, P.L. 101-235 (December 15, 1989).

9. On November 21, 1989, the Senate adopted Senate Resolution 219, which created the HUD/Mod Rehab Investigation Subcommittee to continue the Senate Banking Committee's investigation into the Mod Rehab program and related programs at HUD. Senate Resolution 219 amended Senate Resolution 66 as it related to the Committee on Banking, Housing, and Urban Affairs to add the following:

> (d)(1) The HUD/MOD Rehab Investigation Subcommittee (referred to as the "subcommittee"), a duly authorized subcommittee of the Committee on Banking, Housing, and Urban Affairs, is authorized to conduct an investigation beginning on November 10, 1989, through February 28, 1991, of the management and other activities of the Department of Housing and Urban Development, which occurred before January 1, 1989, surrounding the Moderate Rehabilitation Program under Section 8 of the United States Housing Act of 1937 and related programs, including the use of FHA co-insurance and low income tax credits in connection with Moderate Rehabilitation projects. Such investigation shall include past administrative and programmatic developments that contributed to fraud and abuse in the section 8 Moderate Rehabilitation Program.
>
> (2) For the purpose of the investigation described in paragraph (1), the Committee on Banking, Housing, and Urban Affairs is authorized (A) to require, by subpoena or order, the attendance of witnesses and the production of correspondence, books, papers, documents, and other records; (B) to notice depositions for staff members of such Committee to examine witnesses and to receive evidence at staff depositions under oath administered by an individual authorized by local law to administer oaths; and (C) to require, by subpoena or order, the attendance of witnesses and the production of such records at such staff depositions. The authority of the Committee under this paragraph shall not be delegated to the subcommittee and may be exercised only by the Committee, either by the Chairman with the agreement of the Ranking Minority Member or by a majority vote of the Committee.

(3) The subcommittee shall report its findings, together with such recommendations for legislation as it deems advisable, to the Senate Committee on Banking, Housing, and Urban Affairs to be referred to the Subcommittee on Housing at the earliest practicable date, but not later than February 28, 1991.

10. William Diefenderfer, Deputy Director, OMB, Testimony, Hearings, Vol. 2, April 23, 1990 at p. 153.

11. The Housing Act of 1949, 42 U.S.C. 1441.

12. The Housing and Urban Development Act of 1968, 42 U.S.C. 1441(a).

13. The National Affordable Housing Act, S. 566.

14. The first of these, the Title X program, which provided insurance for mortgages to finance the purchase of land and development of subdivisions was revealed by the HUD Inspector General to have been subject to misuse, notably in one instance wherein Title X finds were used to construct a golf course. The second was the Retirement Service Center Program which was administratively created by HUD in 1983. Under the program HUD provided insurance for mortgages for service centers which provide housing for persons 70 years of age or older who are able to live independently and pay market rates for the housing and services provided. Secretary Kemp found the program to have incurred $116 million in direct losses and that existing mortgages in default totaled $250 million.

15. John Ols, Director, Housing and Community Development Issues, General Accounting Office, Testimony, Hearings, Vol. 1, February 27, 1990 at pp. 152, 154-155; General Accounting Office, Report to the Chairman, HUD/Mod Rehab Investigation Subcommittee, on Rental Housing: Inefficiencies From Combining Moderate Rehabilitation and Tax Credit Subsidies, June 19, 1990.

16. Among those endorsing this position is Ranking Republican Connie Mack. In addition, Stuart Butler, Director of Domestic Policy Studies at the Heritage Foundation, has been quoted as saying that it was a fundamental mistake to fund the supply side and that "the basic systemic problem is that you have loads of cash in HUD to bribe construction companies to do something that is against their economic interest." He believes that 90 percent of the problems could be solved by limiting housing programs to rental assistance and vouchers. Steinbech, C., "Programmed for Plunder," National Journal, September, 16, 1989 at pp. 2261-2262.

17. Marilyn Melkonian, President, Telesis Corp., Testimony, Hearings, Vol. 1, February 27, 1990 at pp. 186-188.

18. Omnibus Budget Reconciliation Act of 1989, P.L. 101-239 (December 19, 1989); Department of Housing and Urban Development Reform Act of 1989, P.L. 101-235 (December 15, 1989).

19. Angus Olson, Executive Director, Alexandria Redevelopment and Housing Authority, Testimony, House Hearings, May 8, 1989 at p. 126. Under the program, as designed, HUD enters into Annual Contributions Contracts with public housing authorities (PHAs) which solicit proposals from owners or developers and determine if the units are appropriate for the program. The PHA enters into a Housing Assistance Payment Agreement (HAP) with the owners of eligible units. Upon completion of the rehabilitation and its approval by the PHA, the HAP contract is executed and the PHA administers a rental subsidy to the owner for 15 years. The minimum amount of rehabilitation is $1,000 per unit and, while no maximum is specified, some control is exercised through the fair market rent calculations for the program.

20. It is not clear from the record when this committee was established. According to Pierce, he created it soon after the fair share requirement was abolished. However, Demery testified that the committee was established in 1987. Equally unclear is who actually participated as members of the committee. The committee was originally established to be composed of the Executive Assistant to the Secretary, the Under Secretary, and the Assistant secretary of Housing, though Pierce was uncertain who was in charge. He testified that he assumed it to be the Assistant Secretary of Housing. Nonetheless, many who were named as participants, including Silvio DeBartolomeis, Shirley Wiseman, and Janet Hale denied having heard of the committee, much less participating in its decisions.

21. The three programs were: (1) the Section 223(f) program, implemented in May 1983 to provide mortgage insurance for the purchase or refinancing of existing multifamily housing projects which are at least three years old and have at least five units; (2) the Section 221(d) program, implemented in October 1984 to provide mortgage insurance for the new construction or substantial rehabilitation of multifamily housing projects; and (3) the Section 232 program, implemented in October 1988 to provide mortgage insurance for nursing homes and other health care facilities.

22. Ranking Republican Connie Mack remains unconvinced that there is a correlation between the reduced staffing levels and the problems at HUD, believing instead that the serious policy flaws in certain housing programs makes it arguable whether any amount of staff could have avoided the problems at HUD.

23. Charles Dempsey, former Inspector General, HUD, Testimony, Hearings, Vol. 2, May 8, 1990 at p. 479.

24. William Proxmire, Testimony, House Hearings, (Unofficial Transcript), July 31, 1989 at p. 10.

25. Alfred Dellibovi, Under Secretary of HUD, Testimony, Hearings, Vol. 2, June 29, 1990 at p. 665.

26. This was one event with which Senator Proxmire took pride, declaring that he had been instrumental in her defeat for appointment to the position of Assistant Secretary for Community Planning and Development because, in his opinion, she was unqualified for the position. He further testified that this would have been even more true had he been aware of some of the matters that had been developed in the congressional hearings regarding her role as Executive Assistant. Proxmire at 76-77.

STATEMENT OF SENATOR CONNIE MACK

I am pleased to have participated in the investigation for which this Subcommittee was authorized to conduct. The Executive Summary which precedes is the product of a comprehensive series of hearings, discussions, and consultations.

The Subcommittee's investigation concentrated on the aspects of certain federal housing programs which were particularly subject to abuse. This attention reflects a view that had it not been for certain flawed housing policies and programs, perhaps an opportunity to squander federal funds would have been significantly reduced.

It is indisputable there were people at the Department of Housing and Urban Development that abused the system. Management, both in Congress and the Administration, failed in its task to responsibly control federal funds flowing through housing programs. As a result, middlemen benefited from funds intended for low income people. This is inexcusable.

Poorly designed programs and large pots of discretionary money predictably led to misuse. Middlemen and consultants wrongly became the mechanism through which applicants secured funding.

Chairman Graham and I generally share similar conclusions regarding this investigation, and many are identified in the Executive Summary. This Summary represents our joint statement at the termination of the investigation. It is significant that we are in agreement on the overwhelming majority of conclusions and recommendations. We do, however, place different emphasis on three issues.

I have little confidence that more staffing, specifically at the career level, would improve HUD's capacity to operate and monitor housing programs. I contend that flawed policies and programs would undermine increased staffing levels. Proper design of programs would allow funds to benefit low income families directly without being diverted to additional bureaucracy.

This policy was made clear in recent housing legislation which became law to allow states and local governments to implement direct rental assitance programs in aiding low-income families.

Direct rental assistance is an efficient way to bypass middlemen and a cumbersome bureaucracy, targeting assistance to those Americans who need it most.

I also cannot agree with the recommendation to separate the management function of the Office of Management and Budget into a separate agency. Isolating the management role is likely to weaken the important link between management and budget.

In general, I am skeptical that either reorganizing bureaucracy or adding bureaucracy at any level of the administration of housing programs will lead to better housing of the nation's poor.

Lastly, I do not support the requirement for the Senate Banking Committee to establish an advisory board to provide confidential recommendations on persons seeking HUD appointments. Members currently have access to all information upon which such recommendations would be based. I fear that the good intentions that inspire an effort to produce confidential recommendations could easily be abused.

While the Executive Summary largely reflects the joint conclusions which Senator Graham and I have drawn -- with the aforementioned exceptions -- the text of the Majority Report does not. Much of that Report, prepared by the majority staff of the Subcommittee and consisting of Parts Two through Four of this document, analyzes the issues from a perspective which I do not share.

In closing, I would like to congratulate Chairman Graham for his fine leadership. His diligence and meticulous attention to important detail produced a respectable and comprehensive investigation.

PART TWO
FINDINGS AND RECOMMENDATIONS

CHAPTER ONE
SUBSIDY LAYERING
SUMMARY

The private sector has played a central role in the production of assisted housing for low income families. However, when a private sector developer undertakes a project, it expects a return that is sufficient to warrant participation. As a result, most government housing programs have grappled with the issue of determining the appropriate level of subsidy necessary to entice developers to produce low income housing without oversubsidizing and wasting public resources.

A key finding among many of the HUD-assisted projects examined in the wake of the HUD scandal was that too often developers received more subsidy than was necessary to produce low income housing. As a means of gaining a greater understanding for how HUD-assisted projects are put together, as well as to examine the role of using public subsidies to make low income projects financially feasible, the Subcommittee held a hearing entitled "Anatomy of a Deal."

First, the hearing explored the concept of balancing risk and return in determining the appropriate level of subsidy. Developers must make a sufficient return to assure they are compensated for both the cost of doing business and for putting their resources at risk. Witnesses testified it would be almost impossible to create an objective set of criteria for evaluating risk and return, since each project is unique. The need for flexibility and room for negotiation was emphasized. It was suggested that oversubsidization can best be prevented through improved oversight and monitoring.

Second, problems associated with subsidy layering and the system for financing the production and rehabilitation of low and moderate income housing were examined. As a means of coping with diminishing Federal housing subsidies, a new, highly inefficient system for financing low and moderate income housing evolved as a means of coping with diminishing subsidies. In order to make low income projects financially feasible, it became necessary to use more than one subsidy. The result of this development has been to increase transaction costs and make it difficult to determine how much subsidy a project is actually receiving. This chapter concludes that housing programs should be adequately and consistently funded such that subsidy layering will be unnecessary. Furthermore, subsidies should be flexible enough to allow states and localities to determine the type of subsidies required to address local needs.

Third, the hearing highlighted problems with subsidy layering and oversubsidization that can be attributed to lack of coordination between direct public subsidies and tax policy. Over the last twenty years both direct and tax subsidies have been needed to produce low income housing. Improved coordination between tax policy and housing programs would result in more efficient use of subsidies.

Finally, the role and necessity of Federal public/private partnerships was reasserted. This partnership deteriorated during the 1980's due to lack of participation on the part of the Federal Government. This chapter concludes that the public/ private partnership has been a valuable means to reach the policy goal of producing housing for low and moderate income persons. Key to reviving this partnership is for the Federal Government to make a renewed commitment to providing affordable housing for all Americans.

CHAPTER ONE
SUBSIDY LAYERING

I. Introduction

Since its creation in 1965, much of HUD's mission, to provide "a decent home in a suitable environment for every American family," has been accomplished through the private sector (both for-profits and non-profit organizations). Private sector developers have produced the bulk of the federally subsidized housing in the nation. Thus, reforms to the agency, as well as new initiatives, must take into account the needs of the private sector.

A financially viable rental housing project must cover the cost of development, financing, operation, and maintenance. For a for-profit developer, the project must also support the expectation of a reasonable return on investment. Market rate housing normally covers those requirements from rental revenues, tax considerations, and appreciation in property values. In the case of low-income housing, those sources are insufficient, and the government has had to step in to close the gap with a variety of subsidies, such as writedown of development costs, rental assistance, financial subsidies, and enriched tax benefits. Assistance available under any one subsidy source typically is not enough to make up the full shortfall. As a result, low-income housing often must make use of a variety of subsidies, provided through several programs administered by different agencies and levels of government. Consequently, the task of determining the proper level of subsidy to achieve the desired public purpose becomes inherently complex. The Subcommittee found that, for too long, no one was given clear responsibility for carrying out that task and, in too many cases, it was simply not done.

A key finding among many of the HUD-assisted projects examined by the Inspector General and Congressional Committees was that often more subsidy was awarded than necessary to ensure that a low income housing project was produced and properly maintained. Developers received excessive profits relative to the risks incurred. Furthermore, oversubsidization occurred most frequently when subsidy mechanisms were layered[1]. While subsidy layering is often required to make low income projects feasible, a delicate balance must be achieved between providing enough incentive and giving away the store.

On February 27, 1990, the Subcommittee held a hearing entitled "Anatomy of a Deal." The Subcommittee selected this topic for exploration both to lay a framework for understanding the process by which HUD-assisted projects are structured and to examine the proper role of government subsidies in making low income projects financially feasible. A question for the Subcommittee was: "how much subsidy is enough to provide developers with an incentive to produce low-income and moderate-income housing?."

In determining the appropriate level of subsidy, it is necessary to consider the relationship between risk and return, and how low income projects can be made an attractive alternative among other investment opportunities. As a part of this inquiry, the Subcommittee asked the question of whether it is possible for the federal government to develop objective criteria to evaluate the relationship between risk and return. In probing these questions, this section will explore the concepts of: 1) balancing risk and return; 2) the evolution and problems associated with "creative finance" and subsidy layering; 3) the use of direct and indirect subsidies; and 4) the importance of the public/private partnerships.

II. Balancing Risk and Return

The development process is risky, and a prospective developer of low income housing takes on a number of additional risks. For example, low-income projects are riskier due to local opposition. In all but the worst locations, government-assisted housing can be subject to fierce resistance. As a result, project preparation can drag on for years, significantly increasing costs. Furthermore, neighborhood opposition and difficulty in obtaining large tracts of land in recent years, have led to the development of smaller, scattered site projects. Scattered site development carries higher costs for construction, coordination and security. Finally, the shortage of subsidy mechanisms in recent years has led developers to layer subsidies. Obtaining multiple subsidies is a time-consuming and costly process which contributes to risk.

If the government wants the private sector to participate in providing affordable housing, it must offer incentives that are competitive with what the developer can make doing something else, and that allow the developer to attract competent staff[2]. Patrick Clancy, Executive Director of the Community Builders, a non-profit developer in Boston, and Sheldon Baskin, a for-profit developer in Chicago, testified before the Subcommittee that government incentives must be designed to provide:

(1) Coverage for anticipated and real overhead, staff time, time value of money spent on up front costs, and a wide variety of direct out-of-pocket expenditures;

(2) A reasonable margin of safety for developers, investors, and lenders who are putting themselves and their capital at risk. Developers are often required to make guarantees or provide security for guarantees made, thus, placing them at a considerable risk. Parties which place their capital at risk, should receive a sufficient return. In short, when determining how high the upside should be allowed to go, it is necessary to determine how low the downside can go; and

(3) An ultimate return potential that is sufficient relative to other competing activities. Presumably, a developer could make money in other ways

instead of producing low income housing. A reasonable margin of profit will provide an incentive and compensate participants for carrying out a public policy objective.

Several Subcommittee witnesses advised against establishing rigid and objective standards to determine the "appropriate" level of profits and fees which developers can earn. They emphasized the need for flexibility, stating that each project is unique and has peculiar characteristics. Returns earned by developers should be commensurate with the unique risks associated with each project. Clancy suggested a number of general principals for determining the appropriate level of subsidy:

(1) Standards for incentive and return should be set that are proximate in time and place to the actors whose productive engagement is sought. Standards need to be set as close to markets as possible and be continually adjusted as conditions which affect the production of housing shifts;

(2) A competitive process should be established for determining what a market requires, what a market will bear in terms of incentives, and what market rates of return are earning;

(3) Standards should be designed to provide an incentive structure which assures maximum utilization of public resources for the desired objective and maximizes cost efficiency; and

(4) Standards should be designed to acknowledge that the bottom line for appropriate public judgement is the overall efficiency of the use of incentives more than the comparison of the return to developers in one project versus another[3].

Clancy discussed the Massachusetts Housing Finance Agency's attempt to establish guidelines for "adequate but not excessive level[s] of return for developers." He indicated that given the complexity of the development process, changing market conditions, the relative capacity of non-profits and for-profit sectors, and the availability of public subsidies, it was difficult to set guidelines that take into account the array of ever-changing factors. Clancy admitted that despite "20 years in the affordable housing business, I don't know enough to propose a magic number or even a range of numbers that represent the right percentage level of return to provide a "just right" incentive level for affordable housing production efforts.[4]"

In conclusion, government programs which depend on the private sector must build in enough profit to induce participation. Even non-profit sponsors need to make an adequate return to pay overhead and ensure they have sufficient capital resources for future projects. If a deal is too risky, both for-profit and non-profit developers will shy away and look for more promising endeavors. This means that government programs should be designed to reward developers who, in their pursuit of profit, contribute to public policy goals. Often low-income housing is not economically feasible enough for the profit-motivated free market system to produce. Therefore, in order to provide affordable housing, the government must take an active role in promoting investment.

III. CREATIVE FINANCE

A. How Did Subsidy Layering Evolve and Why Is It Necessary?

During the 1980's, the federal government abandoned its four decade commitment to providing affordable housing opportunities for all Americans. The Reagan Administration held the view that: 1) providing affordable housing was the responsibility of state and local governments; and 2) government was part of the problem, rather than the solution to social problems. Therefore, it set out to reduce the size and role of federal support for housing. HUD's budget authority was reduced by 80%[5] during the decade and staff was cut by 20%.[6]

Significant increases in housing costs and the unavailability of financing mechanisms which were affordable to low and moderate income persons forced developers to piggy-back multiple subsidies until they were sufficient to reduce project rents to affordable levels. For example, in California during the 1970's when the value of real estate skyrocketed, finance instruments where developed to enable home buyers who could not afford conventional financing to obtain credit. New financing products emerged including balloon loans, seller loans, assumed loans, land contracts, junior liens, unamortized short-term loans, graduated payments and graduated interest payments, as a means of providing much needed flexibility[7]. Some have taken to using the euphemism "creative finance" to refer to these often tortuous efforts to assemble a complex amalgam of subsidies and financial sources.

When the Federal government reduced funding for low income housing programs, the need for subsidy layering greatly intensified. The resources available from any one source were so limited that it necessitated combining -- or layering subsidies -- in order to come up with the funds necessary to make a project financially feasible. Michael Stegman, Chairman of the Department of City and Regional Planning at the University of North Carolina, characterizes the creative finance system as "an ad hoc emergency response to [a] pathological set of conditions: the unprecedented withdrawal of the federal government from its historical role as a long term lender and a subsidizer of new and substantially rehabilitated housing for the poor."[8]

The Brewery, a project in St. Louis, Missouri, which was examined by the Subcommittee at its February 27, 1990 hearing illustrates the complexity, as well as the necessity of multiple financing sources. The project involved the rehabilitation and operation of a 140 unit apartment complex. The development consisted of the historic rehabilitation of the former Columbia Brewery and eleven adjacent town houses. The total development costs of the project were $12.5 million -- or $89,000 per unit. The complex financing structure of the project consisted of the following sources:

1) a first mortgage was provided through $4.3 million in tax-exempt bonds from the Land Clearance for Redevelopment Authority (LCRA) of the City of St.Louis;

2) the tax-exempt bonds that were guaranteed by HUD through the FHA 221(d)(4) mortgage insurance program;

3) a second mortgage of $1.6 million that was provided through an Urban Development Action Grant (UDAG);

4) an additional source for the second mortgage was provided through a Community Development Block Grant (CDBG) for $888,000 from the City of St. Louis;

5) a Section 8 Moderate Rehabilitation contract was awarded by HUD for 45 units for a period of 15 years;

6) an equity contribution of $4.4 million was raised through the syndication of Historic Preservation Tax Credits; and

7) the City of St. Louis paid $325,000 for off site public improvements, including lighting, sidewalks, streets, and landscaping and granted a substantial real estate tax abatement to the project.

Most of the financing for the project tapped Federal resources. The equity contribution was raised through the tax code. The UDAG, CDBG, Mod Rehab rental assistance and 221(d)(4) mortgage insurance were provided by HUD. In addition, the ability of the St. Louis Housing Authority to issue tax exempt bonds was granted by Congress. The developer noted that Federal money was involved in all aspects of the project, including both market rate and subsidized units, because the income stream from the Section 8 rents and market rate units were part of the total financing equation. In summary, he stated that the project could not have be done without federal dollars.

The developer, Richard Baron, testified that this complex packaging is typical of low income projects he has developed. In the absence of state and federal financing sources, Baron indicated it is necessary for inner-city developers doing low income projects to piece together deals from multiple sources. In summarizing the nature of the problem, Baron aptly stated:

> I think part of the problem that one finds with these programs is that, because there is no clear, consistent way of dealing with financing them, you have to go through this patchwork quilt of financing to make deals work, you're forced into finding financing at all levels of government and through the private sector. I think when one steps back from the Brewery project, it took three and a half years to develop 140 housing units and there are 10,000 people on the waiting list at the St. Louis Housing Authority. I think it speaks for itself.[9]

B. What Are the Problems With Subsidy Layering?

As discussed above, a key problem with subsidy layering is that financial packaging of low income projects has become excessively complicated. On a similar note, the use of multiple sources of funds can inflate the costs of producing housing by increasing transaction costs and creating awkwardly structured financing. Stegman points out some of the inefficiencies and chaos created by this system noting the following types of scenarios have become commonplace:

> seller's loans that cannot be repaid from rental income; deferred payment balloons that cannot be paid off unless a low income property is converted to market rate use; graduated payment mortgages that anticipate tenant income to rise faster than the national average based on the hoped-for positive outcomes of employment training and entrepreneurial development programs that are not even in place; put options that enable limited partners to walk away from their investments in fifteen years -- and federal tax credits that are as complicated to use as they are costly to the government to provide -- these have become the instruments of creative finance in the low-income housing sector.[10]

Stegman advocates creating a more rational system for financing housing for the poor. He warns that if a better system is not developed, the costs of doing business for the government and developers will remain unnecessarily high, and too much energy will be spent on financial packaging rather than providing much needed supportive services. He asserts that the complex structure of many projects emphasizes the most serious failure of a housing policy based on subsidy layering. He states that "it simply doesn't make sense to have a national housing policy in which the deeper the targeting and the lower the income group served, the more complicated and costly it is to arrange financing."[11]

As a means of simplifying the low income housing finance system, Baron advocated creating a housing block grant program that would distribute Federal funds to local governments and permit the localities to set their own priorities. This approach would allow developers to seek funding from one source, rather than several programs[12] These sentiments were echoed by Karen Kollias, Vice President of American Security Bank's Community Development Group, in testimony before the Subcommittee. She asserted that the Federal government should set priorities and make incentives available to localities, but allow localities to make the decisions about what investments are needed in each neighborhood.[13] Such a single financing source would eliminate the high transaction costs which characterize many low income projects. The National Affordable Housing Act, recently enacted by Congress, creates a formula-based program of housing assistance that will grant States and local governments the flexibility to use Federal funds to meet locally determined needs.

Congressional investigation into the HUD scandal has revealed another critical problem with the creative finance system. Often, when subsidy mechanisms are layered, a project can receive more resources than are necessary to provide affordable housing. This situation occurred because no government agency had the responsibility to look at the whole package of incentives to be used on a given project. Morton Schussheim of the Congressional Research Service concluded that "one of the most obvious derelictions of HUD administrators, in hindsight, was the failure to hold subsidies to the amounts necessary to get the desired results."[14]

Sierra Point, a project in Las Vegas, Nevada, clearly illustrates the problem of oversubsidization and lack of government oversight. The project involved the rehabilitation of the former Patti Ann Apartments in Las Vegas, Nevada. The development consists of 160 units with total development costs of $8.8 million -- or $55,000 per unit. A first mortgage of $7.4 million was coinsured under HUD's Section 221(d)(4) mortgage insurance program. In addition to mortgage insurance, HUD granted a Section 8 Moderate Rehabilitation rental assistance contract for the units. Equity for the project -- $2.3 million -- was primarily raised through the Low Income Housing Tax Credit.

The key to understanding the oversubsidization of Sierra Point, as well as other projects involved in the HUD scandals, is not that the subsidy programs were inherently flawed when considered separately. Rather, it was the layering of several subsidy programs that often created unintended consequences, such as oversubsidization and windfall profits. For example, Sierra Point received several subsidies -- FHA coinsurance, a Moderate Rehabilitation contract, and the low income housing tax credit. HUD's Inspector General found that problems arose when Moderate Rehabilitation subsidies were combined with coinsurance. It was alleged that HUD did not provide adequate guidance when there were discrepancies between the requirements of the two programs[15].

Moderate Rehabilitation subsidies are based on HUD's Fair Market Rents. Fair Market Rents are the maximum rents that can be charged for units under the program. Generally, the Moderate Rehabilitation subsidy is calculated by the Public Housing Authority and HUD using the Fair Market Rents. In contrast, under the FHA coinsurance program, private lenders were given the discretion to underwrite projects -- including setting rents and vacancy rates. The Inspector General found that often when the two programs were combined, the co-insurers ended up setting the rents and consequently determining the amount of Moderate Rehabilitation subsidy that was awarded. As a result, often, more subsidy was awarded than necessary to complete the project[16].

Finally, the low income housing tax credits were added to the Sierra Point financing package. The developers testified before the Subcommittee that when the project was originally put together in early 1986, they had not considered using the tax credit. However, after the tax credit was created in the Tax Reform of 1986, they applied for and received an allocation from the State of Nevada. The developers admitted that this award was not necessary to complete the project and represented a "windfall."[17] In an analysis of the project, the General Accounting Office estimated that the Sierra Point project realized cash flows of approximately $1.8 million -- or 22% above the cost to acquire and rehabilitate the project. The cash flows realized were derived from the proceeds of tax credits and the Section 8 Moderate Rehabilitation Program.

In a 1989 analysis of eight Moderate Rehabilitation projects which used tax credits (including Sierra Point) the General Accounting Office concluded that "there is a real danger of providing too much financial assistance to a developer when multiple subsidies are awarded to individual projects without a review of the total amount of assistance."[18] John Ols, Director of Housing and Community Development Issues at the General Accounting Office, testified before the Banking Committee that "when the developers sold their ownership interests in these projects along with the related tax credits, and when these proceeds were combined with mortgage loans and other sources of funds, the developers realized cash proceeds far greater than the costs associated with acquiring and rehabilitating the properties."[19] Furthermore, GAO testified that the Moderate Rehabilitation Program and the tax credit provides no incentive to reduce the costs of a project. Notably, the tax credit provides an incentive to increase costs because the tax credit is calculated as a percentage of rehabilitation and acquisition costs. Therefore, developers have an incentive to inflate or incur unnecessary costs. Again, without adequate governmental oversight, there is a danger of providing excessive subsidies.[20]

The General Accounting Office also warned that subsidies were used inefficiently. The General Accounting Office concluded that it was inefficient to use the Moderate Rehabilitation Program with tax credits in housing markets that already have an adequate supply of existing rental housing. At the time Sierra Point was approved and during its development, estimates of the local vacancy rates for rental units ranged from four to eight percent. These estimates, given the approximately 80,000 rental units in the local market, suggest that there may have been several thousand vacant units. The General Accounting Office stated that it is highly likely that 160 units would have been available in the market to house low-income families. Moreover, the director of the local Public Housing Authority told the Subcommittee that when the project was approved, low income families were not experiencing any difficulty finding housing using HUD's Section 8 certificate program. The General Accounting

Office analysis demonstrated that if certificates had been used instead of the Mod Rehab program and tax credits, about 419 households could have been assisted rather than the 160 assisted in the Sierra Point project. In other words, an additional 259 households could have been assisted.[21]

The HUD Reform Act of 1989, enacted in the wake of the HUD scandal, attempted to grapple with the concept of determining how much subsidy is enough and the government's role in ensuring that projects are not overly enriched. The Act requires developers to disclose:

> Information regarding any related assistance from the Federal Government, a State, or unit of general local government, or any agency or instrumentality thereof, that is expected to be made available with respect to the project or activities for which the applicant is seeking assistance. Such related assistance shall include but not be limited to any loan, grant, guarantee, insurance, payment, rebate, subsidy, credit, tax benefits or any other form of direct or indirect assistance" [... as well as] the expected sources and uses of funds that are to be made available for the project or activity.[22]

Marilyn Melkonian, President of the Telesis Corporation, testified that the HUD Reform Act "introduces an entirely new approach in the relationship between private owners and HUD in determining what the amount of public investment in a project should be."[23] The Act requires HUD to look at the total package of financing, including direct subsidies and indirect tax incentives. Furthermore, the Act forces HUD to attempt to define the appropriate relationship between risk and return.

Stegman expressed concern over this provision of the HUD Reform Act. He argued that even if all this detailed information could be provided in the early stages of the development process, HUD no longer possesses the staff capacity to process and review the information. Furthermore, he stated that "like an equation that has too many unknowns to have a unique solution, a creatively financed tax credit project that requires all financing components to be locked in before any will be committed cannot be underwritten."[24] Stegman warns that this provision of the HUD Reform Act could impede the production of low income housing, as well as substantially increase transaction costs -- instead of creating financing programs that minimize total resource costs.[25]

Subsidy layering has evolved as a means for low income developers to cope with diminishing federal subsidies. However, as indicated above, such layering has lead to significant difficulties in the form of increased transaction costs and awkward financing structures. Furthermore, as discovered through examination of many HUD-assisted projects, it can also lead to oversubsidization. While the HUD Reform Act was intended to address some of the problems associated with subsidy layering and oversubsidization, there is concern that excessive oversight could effectively halt the production of housing.

IV. Direct vs. Indirect Subsidies

For the past twenty years, the federal government has played a role in subsidizing housing through both direct and indirect subsidies. In testimony before the Subcommittee, Clancy stated "it has consistently been the case in my experience over these last 20 years that generally both direct assistance and investment incentives are necessary to create affordable housing and neither are in and of themselves provided at a level to be totally self-sufficient."[26]

Direct subsidies encompass capital and operating subsidies that are primarily available through HUD. Indirect subsidies include tax benefits provided through the Internal Revenue Code. As discussed above, the low income housing tax credit played a central role in the HUD scandal. In the wake of HUD's diminished role in the production of low income housing, the tax credit was the only game in town. This section will focus primarily on the role of indirect subsidies and the need for greater coordination of both types of benefits.

Clearly, there are advantages and disadvantages to using each type of benefit. A key benefit of direct subsidies is that they can be targeted to achieve a specific result and tailored to meet local conditions Furthermore, their impact is more quantifiable than tax benefits. However, direct subsidies can be very costly to administer and involve navigating a maze of bureaucracy in order to receive an allocation.[27]

There are several advantages of using tax incentives. First, it avoids the substantial costs associated with the bureaucracy of government programs that allocate direct incentives. Tax benefits can induce private investment capital to achieve government objectives as investors have greater certainty of receiving a benefit via the Internal Revenue Code than through other government agencies. However, there are also negative consequences of using tax incentives. Tax subsidies are inefficient because only a portion of every dollar of tax credit goes to its intended purpose -- the remainder is lost through transaction costs. Without proper government oversight, tax expenditures are vulnerable to abuse, as evidenced by the award of low income housing tax credits to Sierra Point. Baskin was particularly critical of using tax incentives stating that the:

> Internal Revenue Code is an inherently inexact method of subsidizing anything...it doesn't pinpoint government assistance to where it is most needed or has the most impact...the more you try to pinpoint the assistance through the Code the more administration is required, without ever achieving the full benefits of a directly administered subsidy program.[28]

Indirect benefits derived through the tax code have a tremendous impact on the construction and rehabilitation of low income housing. Changes in the tax laws have created ebbs and flows in the volume of housing produced over the last twenty years. Prior to 1981, Congress enacted a number of tax code provisions that enhanced investment in low income housing. These benefits primarily affected depreciation deductions, current expense deductions, capitalization, and taxable gain on sale of low income housing.

Depreciation deductions were the principal tax benefit available to developers and investors. A depreciation deduction for real estate reflects the expense of the presumed "using up" of an asset. The 1969 Tax Act granted favorable treatment to newly constructed and rehabilitated projects by allowing them to be depreciated over the useful life of the asset using a 200% declining balance. In contrast, the Act also required existing projects in-use by tenants to use a 125% declining balance.[29] The 1969 Act also changed depreciation rules such that the average life of most assets decreased from 30 to 40 years to 20 to 25 years. Shortening the life of an asset allows investors to write-off a larger portion of the asset over a shorter period of time. Finally, the Act permitted expenses from the substantial rehabilitation of low income housing to be written off over a 5-year period.

In addition to generous depreciation allowances, the Code granted other favorable provisions to low income housing. First, operating expenses payable from cash flow were ruled to be currently (as incurred) deductible prior to 1980. In particular, interest on debt service of a HUD-insured mortgage was treated as a deductible cash expense. Second, investors in low income housing were permitted to capitalize construction interest and taxes as incurred. In contrast, market rate housing investors were required to capitalize these expenses over 10 years.

Finally, the taxable gain on the sale of property gave preferential treatment to low income properties. For market rate housing, accelerated depreciation deductions in excess of the straight line deductions where required to be recaptured and taxed at ordinary rates upon sale of the asset. In contrast, the code eliminated the tax on the recovered excess over time for low income properties. Furthermore, upon sale, the gain on both low income and market rate housing was taxed at the lower capital gains rate rather than the higher ordinary income rate.

The Economic Recovery Tax Act of 1981 spurred a boom in construction and rehabilitation. Two provisions of the Act had a substantial impact on low income housing. First, the maximum Federal tax rates were lowered to 50% and the Accelerated Cost Recovery System (ACRS) was adopted. ACRS permitted a 200% declining balance (accelerated) depreciation of low income housing over a 15 year period and could be used on new and in-use projects. ACRS prompted developers to re-syndicate older projects and generate sufficient cash to cover repairs. Second, investors were still able to use the passive losses generated by low income properties to offset other income. In summary, lowering the federal tax rate and adoption of the ACRS greatly expanded the pool of investors seeking tax shelters.

The Tax Reform Act of 1986 marked a serious blow to low income housing because it: 1) imposed limitations on passive losses; 2) lowered the tax rate on ordinary income; 3) eliminated the capital gains exclusion; and 4) imposed a straight-line depreciation schedule over 27.5 years, rather than accelerated depreciation. However, the 1986 Act also created the low income housing tax credit. The credit is equivalent to 9% of the qualified basis for new construction and substantial rehabilitation, and 4% for acquisition and on projects which received other Federal subsidies.

In the years since the credit was adopted, it has been discovered that many restrictions on the credit can make it difficult to use. However, in the absence of other tax benefits and direct subsidies, many of the few remaining low income developers support its continuation. Stegman commented that:

> given the hostile housing environment that existed when it was enacted, it is no wonder that the low income advocacy community rallied behind a tax credit whose cost to the government may be as much as twice as great as the dollars it delivers to projects; tax credits whose value to the developer has been estimated to exceed 50% of the development cost, but when accompanied by no other housing subsidies cannot produce housing affordable to the poor.[30]

It is generally perceived that the Tax Reform Act of 1986 has discouraged investment in low income housing.[31] The 1986 Act withdrew a system of provisions that acted as a catalyst for construction and rehabilitation largely due to depreciation allowances. The availability of tax benefits was found to be essential in providing an adequate rate of return to developers and investors of low income housing. In the absence of real estate tax benefits, many owners, developers and investors have sought other more lucrative investments.

The Mitchell-Danforth Task Force on the Low Income Housing Tax Credit concluded that "the Credit alone cannot make projects feasible, except under special market conditions and circumstances. Therefore, subsidy enhancements which are needed to make the tax credit projects viable in all national markets should be encouraged. These additional sources of subsidy should be derived from the tax code and from direct spending programs."[32] This point was echoed by Clancy who stated:

> It was clear to virtually all of us in the industry that the low income housing tax credit would only produce affordable housing where it could be used in combination with direct assistance. Thus, the issue more appropriately was not whether direct assistance were being combined, but whether the aggregate combined level of resources in the context of the cost of the project

> being undertaken, the level of affordability being provided, and the level of return necessary for developers and investors in the marketplace were in the aggregate reasonable or unreasonable.[33]

Despite the critical role played by both indirect and direct subsidies, it is surprising that no governmental agency was responsible for looking at the whole package of incentives. Clancy aptly summarized this point stating:

> ... in the face of a consistent 20-year experience of affordable housing being produced only where public assistance and investment incentives through the tax code are both utilized, the worlds in which each form of public support exists have been totally separate worlds and the public actors in each of them have never taken into account the public role and actors in the other. More specifically HUD never understood, nor tried to understand, in its various insurance and subsidy programs the value, relevance or importance of investment incentives available to the projects it financed through the tax code. This may sound hard to believe given the recent investigations and the clear inter-relationship of direct assistance and investment incentives, but let me stress that it has been the status quo for 20 years...this complete independence of the world of direct assistance and investment incentives quite logically led to highly inconsistent levels of efficiency in the combined outcomes.[34]

Direct and indirect subsidies have played a critical role in the production of low income housing over the past twenty years. Clearly, both forms of assistance are needed in order to effectively create affordable housing opportunities. However, as discussed above, policy makers have not always considered the implications of combining both forms of assistance. In developing future financing mechanisms, policy makers need to focus more attention on coordinating direct assistance and tax mechanisms.

V. Restoring Partnerships

Public-private partnerships are joint ventures between the public and private sector (both for-profits and nonprofits) created to carry out a public policy objective. It has long been recognized that the private sector has specialized skills and resources for financing and producing housing that are not possessed by public entities. Thus, in order to achieve the national goal of affordable housing, it becomes necessary to seek the productive engagement of the private sector. As Congress formulates and embarks on new Federal housing initiatives, it is critical to recognize the historic role played by private sector developers.

In 1949, when Congress enacted the National Housing Act, it set forth an ambitious goal of providing decent and affordable housing for American families. In the 40 years since this goal was established, a number of federal programs have been enacted to achieve this end. However, the Federal government's most significant achievements have occurred through partnership with others.

In 1934, when the nation was amidst the Great Depression, the Federal Housing Administration was created to facilitate home ownership by lowering downpayments and providing mortgage insurance. As a result, the percentage of owner-occupied homes rose from under 48% to over 65% in 1980[35], largely due to federal government support. Likewise, Congress established the secondary mortgage markets through the creation of Fannie Mae, Ginnie Mae and Freddie Mac to enhance liquidity by providing a market for the purchase and sale of mortgages. As a result, lenders were able to issue loans for longer periods and at lower monthly payments to homeowners.

In 1959, with the creation of the Section 202 elderly housing program, the federal government embarked on a policy directive of ensuring that persons at the bottom of the economic ladder would have access to affordable housing. This policy has been carried out through a number of direct assistance and credit enhancement programs. Subsequent Federal programs created in the 1960's and 1970's have drawn on public-private partnerships by providing direct loans, subsidized interest rates and rents, grants, and rental assistance to the private sector. Today, 800,000 units of private housing is occupied by tenants receiving certificates or vouchers; 2.2 million privately-owned federally-assisted units have been created through the Section 221(d)(3), Section 236, and the Section 8 new construction, substantial and moderate rehabilitation programs. As a result of these and other Federal public-private initiatives, about 4.4 million units -- or 5% of the nations housing supply -- is federally assisted.[36]

In order to restore the Federal public-private partnership, both Baron and Melkonian emphasized that there must be a commitment to housing on a national level. Baron stated "where there is no interest at the national level and no commitment on the part of the Administration to see any kind of housing done, then all the problems ensue.[37] Baron testified that in order for HUD to become a full functioning partner, there must be a renewed commitment on the part of the federal government to provide affordable housing.[38]

In summary, public-private partnerships have been an integral part of creating affordable housing over the past fifty years. If the private sector is expected to help achieve public policy objectives, reforms to the agency and new initiatives must take into account the needs of this half of the public-private partnership. In order to restore this partnership, the Congress and the President must make a renewed commitment to affordable housing. Furthermore, the Federal government must act as a good faith partner by consistently funding programs and properly managing and overseeing their administration.

VI. Recommendations

In its examination of various subsidy mechanisms created by Congress and their administration during the 1980's, the Subcommittee found a number of serious design flaws which were exacerbated by mismanagement. Nonetheless, in furthering the public-private partnerships necessary to meeting the affordable housing needs of the country, Congress must be sensitive to abuses in the past and formulate programs that either eliminate opportunities and incentives for abuse or provide for adequate monitoring to minimize abuse.

RECOMMENDATION:

Congress must formulate programs in a manner which simplify administration and eliminate opportunities and incentives for abuse, especially in programs which involve the private sector in their implementation.

It would be difficult, at best, to develop an objective set of criteria by which to evaluate whether a project was receiving an appropriate level of subsidy. The appropriateness of a given level of subsidy is largely determined by context, such as market conditions and the level of risk associated with a development.

Federal housing programs should allow States and local governments to use funds to meet the actual needs of their housing markets. The housing needs of every community are different. Federal subsidies should permit States and local governments the flexibility to use funds to meet locally determined needs. As the Public Housing Director in Clark County, Nevada testified given a choice, he would have preferred to use Federal funds for rental assistance rather than rehabilitation given the needs of the community at that time.

RECOMMENDATION:

Federal subsidies should be flexible and allow room for negotiation.

If Federal housing programs are funded at adequate levels, excessive subsidy layering will not be necessary. The current low income housing finance system is too complicated because it requires excessive subsidy layering in order to make projects financially feasible. This patchwork system of finance is inherently inefficient and increases the costs of producing low income housing.

RECOMMENDATION:

Federal housing programs should be adequately and consistently funded and consistently designed to facilitate planning and management.

HUD needs to achieve a delicate balance between providing enough oversight to ensure that the whole package of incentives is taken into consideration when awarding subsidies, and imposing a bureaucratic morass that impedes the delivery of housing to those in need.

HUD should enforce existing sets of checks and balances. In particular, monitoring should be enforced. In order to better perform its existing functions, staff should be given adequate training and development opportunities such that they will be able to recognize and address problems.

RECOMMENDATION:

HUD should ensure that projects are not oversubsidized through improved oversight and monitoring of subsidy programs.

Improved coordination is needed between Federal tax policy and direct housing assistance programs. Both direct and indirect subsidies are an important part of the equation in the production of affordable housing. Better coordination could enhance the development environment for the production of low income housing.

RECOMMENDATION:

Congress must improve coordination between Federal tax policy and housing programs.

ENDNOTES

1. John Ols, Director of Economic and Community Development Issues, GAO, Testimony, Sept. 29, 1989 at p. 479.

2. Sheldon Baskin, Developer, Testimony, Hearings, Vol. 1, Feb. 27, 1990 at p. 231.

3. Patrick Clancy, Executive Director, The Community Builders, Testimony, Hearings, Vol. 1, Feb. 27, 1990 at p. 256-7.

4. Clancy at p. 255.

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CHAPTER TWO
FAIR MARKET RENTS
SUMMARY

One of the abuses of the Section 8 Moderate Rehabilitation Program involved oversubsidization of developers from the payment of excessive rents. The mechanism used to determine the rent structure and federal subsidies under Section 8 programs is the Fair Market Rent (FMR). FMRs are the maximum rents that can be charged and are intended to represent the typical cost of rental housing available in the private market. HUD's Inspector General and Congressional hearings have revealed a number of flaws in the FMR system that enabled developers to collect excessive rents.

First, FMRs were based on old data which did not reflect local market conditions. Therefore, in some cases developers were able to charge rents that exceeded the true market value of the Mod Rehab units. Second, the rent calculations did not take into account rapid changes in market conditions. Finally, when the Mod Rehab program was combined with the coinsurance program, there was confusion over which program guidelines applied. This confusion often resulted in rents being underwritten at levels exceeding those permitted under the Mod Rehab program.

CHAPTER TWO
FAIR MARKET RENTS

I. Introduction

On September 18, 1989, the Senate Committee on Banking, Housing and Urban Affairs held a hearing on the rent structure of the Moderate Rehabilitation Program. Witnesses at an August 2, 1989 hearing of the full Committee testified that excessively high rents contributed to developers reaping excess profits on these HUD-assisted projects.

Two key problems systemic to the manner in which these rents are calculated were explored. First, often rents were calculated using old data which did not reflect local market conditions. Second, rent calculations did not take into account changing market conditions. Therefore developers were able to charge rents that exceeded the true market value of the Moderate Rehabilitation (Mod Rehab) units. A third flaw that permitted developers to charge excessive rents occurred when the Mod Rehab program was combined with the co-insurance program. Each of these problems will be discussed below.

HUD's Office of Inspector General issued an audit on September 26, 1989 which made several findings with respect to problems with the Fair Market Rent (FMR) system. Fair Market Rents are the method used to determine rents on HUD-assisted units under the Section 8 program. First, there were indications that developers of Mod Rehab projects selected properties in areas where HUD's FMRs were high relative to going prices and rents of existing rental properties. Second, developers were able to reap excess profits from a situation in which property values and rents were softening, or even collapsing, while FMRs remained comparatively high. Finally, the data used by HUD in setting FMR's is not always current or geographically specific. Consequently, FMRs are sometimes set too high, which can result in Public Housing Authorities oversubsidizing tenants. Or, FMRs are set too low, which can result in tenants having to pay excessive rent burdens or having difficulty in finding units.

II. Fair Market Rents

A. What are Fair Market Rents?

Fair Market Rents are the ceiling rent schedules for determining the eligibility of rental housing units for the Section 8 Existing Housing program. In other words, FMRs are the maximum rents that can be charged for units under the program. FMRs represent the typical cost of rental housing available in the private market.[1]

The Department's objective in setting FMRs is to assure that an adequate supply of rental housing is available to tenants. Therefore, FMRs must be high enough to allow a choice of units and neighborhoods, and low enough so as many low income families as possible can benefit from the program.

B. How Are FMRs Calculated?[2]

The level at which FMRs are set is expressed as a percentile within the rent distribution of standard quality rental units. The percentile standard used is the 45th percentile rent for recent movers, the dollar amount below which 45 percent of the standard quality rental housing units rent. The 45th percentile is drawn from the distribution of rents of units occupied by households who moved with two years of the rent survey used for an area.

In developing FMR estimates, HUD uses data from the decennial Census, American Housing Survey, and the Consumer Price Index. All FMRs are adjusted annually with CPI data that is available for 72 metropolitan areas and four Census regions. Forty-four of the largest metropolitan areas are updated every four years with the American Housing Survey. Approximately half of all renters in the nation live in these areas. FMRs for all areas are updated every ten years when the results of the decennial Census become available.

The existing housing fair market rents described above are the base upon which Mod Rehab FMRs are calculated. Under the Mod Rehab Program, the FMRs are 120% of the FMRs in the Existing Housing Program. This 20% add-on is intended to over the additional costs of debt service on the rehabilitated units. Mod Rehab projects are also permitted to request the use of exception rents above the published Mod Rehab FMRs.[3] These exceptions cannot exceed 20% of the Mod Rehab FMR. The maximum Mod Rehab FMR is equivalent to 140% of the Existing Housing FMR.

III. Problems with FMRs

A. Old data and Changing Market Conditions

On September 26, 1989, the Inspector General issued an audit of the FMR calculation process. The audit cited three major findings.

First, the IG concluded that the current FMR system is generally sound, but could be improved through the collection of more market-oriented and timely data. The IG felt that the FMR system produces reasonable results for most areas, particularly metropolitan areas covered by the American Housing Survey. However, the method can result in unreasonable variations in some areas. The variations were thought to be primarily due to sampling and estimating problems and tend to occur most likely in certain non-metropolitan and rural areas not covered by the AHS and CPI surveys.[4] The crux of the data problem lies in the frequency in which the data is collected. As stated, FMRs are based on decennial census data. However, by the time HUD receives this census data, it is five years old and fails to take into account any market shifts during that period. Furthermore, by the time HUD updates this data with a new census, the old data can be as much as 15 years old. Furthermore, the IG and GAO have found that adjustments made to the FMR between each census, such as the annual adjustment for local rent and housing quality, are not geographically specific, and can therefore lead to distortions in the FMR.

Second, the IG expressed the opinion that Regional and Field EMAD staffs have not had a significant role in reviewing local rental markets and determining the propriety of prevailing and proposed FMRs in the Section 8 Existing Housing Program. The IG asserted that this has occurred because Headquarters believes Regional and Field staffs technical reviews of program applications are a higher priority than FMR reviews.

Third, the IG suggested that HUD's technical requirements for submitting public comments are not always consistently enforced and are different, resulting in submissions being based on a variety of data from various sources.

HUD's Office of Policy, Development and Research (PD&R) strongly disagreed with the conclusions reached by the IG. PD&R argued that several statistical shortcomings in the rest of the analysis made it impossible to draw conclusions about the FMRs nationally. Although PD&R disagreed with the methods used by the IG, it did concede that "estimates for non-metropolitan areas not covered by the American Housing Survey or CPI surveys pose the greatest problems."[5] The Regional CPI figures, which are used to provide an annual update, are only estimates. The longer CPI estimates are used rather than area-specific data, the more likely it is that FMR estimates will be inaccurate. This is because the estimates do not reflect changes in these housing markets can occur over time. Often, changes in markets or submarkets can occur relatively quickly.

An August 1986 report by the General Accounting Office (GAO) on Fair Market Rents concluded that "because of limitations in the available central data sources that HUD uses, its schedules of FMRs and its annual rent adjustments are not representative of rents in all market areas." The GAO criticized HUD's data as not being current or geographically specific.[6]

In testimony before the Senate Banking Committee in 1989, GAO repeated its 1986 recommendation that HUD needed identify areas where FMRs may be either too high or too low, and make necessary adjustments.[7] GAO recommended that the Secretary of HUD determine whether similar rent disparities exist in other areas of the country and take appropriate action to resolve the disparities and minimize their recurrence.

B. Fair Market Rents and Oversubsidization

During testimony before the Senate Banking Committee, HUD IG Paul Adams stated that the FMR rent determination system resulted in making economically depressed markets with high vacancies attractive to developers. Adams indicated that since there is a lag between the time that the FMRs are set and when they are readjusted, if a real estate market becomes soft over a short period of time, the FMRs will still be higher than the actual market. Thus, developers were attracted to these markets because acquisition costs were low and the FMRs were high.[8]

Adams' testimony was reiterated by Dr. Morton Schussheim of the Congressional Research Service (CRS). A CRS analysis of 20 Moderate Rehabilitation projects that were combined with coinsurance concluded that thirteen out of twenty projects studied were in rental markets that were weak or softening at the time the projects and contract rents were approved. Furthermore, CRS stated that of the remaining projects in the sample, while they were in strong metropolitan markets, may have been located in softer submarket pockets and could have benefitted from relatively high FMRs for the entire area.[9] Schussheim stated that HUD lacks adequate data to set fair market rents in a definitive manner.

Schussheim concluded that it was a reasonable to infer that a knowledgeable developer would seek out situations where properties could be obtained at comparatively low prices and with the hope or expectation of having subsidized rents set at or close to the maximum permitted under HUD's Fair Market Rent schedules. Furthermore, the CRS analysis concluded that a number of projects were able to obtain contract rents close to 120% of the FMR for existing units, the maximum usually allowed by HUD for Mod Rehab projects. The contract rents in these projects were high in comparison with average rents of existing housing already under Section 8 contracts in the same area. The CRS analysis concluded that finding an Mod Rehab project in a soft market was a good way for a developer to begin to reap excessive profits from a project. Schussheim echoed the GAO's comments that the FMRs' problems lie with inadequate or old data.

C. The Impact of Co-insurance

Many of the Mod Rehab projects that have been revealed as having been oversubsidized were co-insured. The co-insurance program exacerbated the FMR problems discussed above by raising questions about who calculated the rents, under what criteria, and when.

In his April 26, 1989 audit of the Mod Rehab program, the Inspector General found that a significant of co-insured Mod Rehab projects had failed to follow HUD regulations with respect to the determination of rents. While the

Mod Rehab program requires the public housing authority to determine rents, when co-insurance was involved, the public housing authorities allowed the co-insuring lenders to perform this duty.[10] Much of the problems occurred because HUD failed to provide adequate guidelines as to which handbook instructions were applicable when the Mod Rehab and co-insurance programs were used in tandem.

Sierra Point in Las Vegas, Nevada, is a project that provides a good example of these problems. The Clark County Housing authority was awarded 160 Mod Rehab units in May 1986 to be used for the rehabilitation of the Sierra Point apartments. William Cottrell, the state housing director testified before the Subcommittee that he contacted the HUD San Francisco regional office for clarification of the roles of the developer, the co-insurer, and the public housing authority in administering a co-insured Mod Rehab project after the developer had indicated that the co-insurer made the rent calculation. Cottrell said that HUD was unable to clarify the roles and, as a result, the rents were determined by the co-insurer and subsequently approved by the regional office.

This illustrates a point made elsewhere in the report that HUD programs must be clear and consistent if they are to be administered in a fashion that minimizes the opportunities for abuse.

IV. RECOMMENDATIONS

As means of addressing the problems with the Fair Market Rent calculation process cited above, PD&R has begun to explore a Random Digit Dialing (RDD) telephone survey instrument. The RDD method involves a random telephone survey of renters in a given geographic area. The results of the survey are compared with the calculated FMRs and used to determine the accuracy of -- or need to adjust -- the FMRs.

The RDD method was tested in Cincinnati, Detroit, Houston, and San Diego and found to produce results that were close to the calculated FMRs. PD&R concluded that the regular use of this survey instrument would significantly improve the Annual Adjustment Factors and the FMRs, as well as save money. PD&R recommended that RRD method be used to provide change factors, test the accuracy of suspect FMRs, and to document appeals.[11]

These commendable efforts to assess the accuracy of fair market rents should be expanded nationwide.

RECOMMENDATION:

HUD should conduct a comprehensive study which assesses the accuracy of the Fair Market Rents relative to actual market rents. The results of this study should be submitted to the Congress.

In addition to collecting data, HUD should continue to be mindful of the complexities of calculating fair market rents which accurately reflect rental rates in a given area.

RECOMMENDATION:

HUD should explore alternative methods for incorporating more market-sensitive data into the Fair Market Rent calculation -- particularly in those non-metropolitan and rural areas not covered by the American Housing Survey or Consumer Price Index surveys. In so doing, HUD should proactively solicit comments from PHAs and Area Offices on the accuracy of Fair Market Rents.

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CHAPTER THREE
CO-INSURANCE
SUMMARY

Congress first authorized co-insurance in 1974. HUD began to co-insure loans under the Section 223(f) program in May 1983, under the Section 221(d) program in October 1984, and under the Section 232 program in October 1988. Under co-insurance HUD/FHA delegated the insurance underwriting function to private lenders and agreed to share insurance premiums in consideration for the lenders' assumption of 20% of the risk of loss on co-insured loans. By reason of the securitization of co-insured loans with Ginnie Mae's guarantee assistance and HUD/FHA's indemnification of Ginnie Mae against loss HUD/FHA in fact assumed 100% of the insurance risk.

The co-insurance programs were poorly conceived and ineffectively administered. HUD/FHA has established loss reserves of $960 million, and GNMA has established loss reserves of $50.5 million, because of losses expected from the business failures of co-insurers and defaults on co-insured loans. Additional losses are anticipated.

The program design flaws included:

-- providing an assured source of loan funding through the securitization of co-insured loans with GNMA guarantee assistance without establishing and enforcing adequate controls over the quality of loans funded;

-- requiring marginal equity capital of program participants and allowing program fees that created strong incentives for co-insurers to focus on the origination of an high volume of loans rather than on loan quality and long term loan collection;

-- failing to establish a leverage limitation that would have controlled the co-insured loan portfolio of any one lender and would have prevented the concentration of insurance risk that HUD permitted;

-- establishing "lowest common denominator" criteria for participation in the co-insurance programs and inadequate methods for screening program applicants that discouraged participants from valuing their credit relationship with the Federal Government;

-- failing to anticipate the liquidity "squeeze" that co-insurers would experience, when loans defaulted, and the resulting incentive of co-insurers to originate new loans and to proceed to foreclosure and project sale as soon as possible;

- failing to anticipate the need for as broad a scope of remedies to address loan defaults as is available under the full insurance programs; and
- failing to anticipate the need to monitor lender compliance with program requirements.

The implementation failures in the co-insurance programs included:

- the failure to develop internal systems of control and financial management systems that would enable HUD to report accurately the financial status of the co-insurance programs;
- the failure to develop data systems and in-house staff capacity to monitor HUD/FHA's credit risk and to respond to project loan defaults and lender failures; and
- the failure to exercise available administrative sanctions against non-complying lenders.

HUD/FHA could mitigate its future losses by taking several actions. These include timely retirement of the GNMA-guaranteed securities that are backed by defaulted co-insured loans, facilitating loan workouts where feasible, and improving the monitoring of lenders and their co-insurance portfolios.

Co-insurance or risk-sharing remains valid as a concept. HUD's failures in implementing the co-insurance authority merely illustrate that a sound concept can be poorly executed.

HUD/FHA has proposed replacing the co-insurance programs with full insurance programs that rely upon private lenders to process loan applications but leave the ultimate underwriting decision with HUD/FHA. There are a number of actions that HUD/FHA needs to take to implement the proposed program successfully. These include restoring insurance underwriting capability at HUD/FHA, resolving systemic problems with HUD's systems of internal controls and financial management, focusing initial underwriting activity in well-known loan programs and markets, sharing risk with private lenders, setting standards for program participation that encourage lenders to value their relationship with HUD/FHA, providing for monitoring of lenders and their portfolios, and defining clear program and actuarial objectives.

CHAPTER THREE
CO-INSURANCE

I. Introduction

A. Reason for Subcommittee Inquiry

HUD has identified the co-insurance programs as its "top material weakness" among all HUD programs that have material weaknesses in internal controls and financial management systems.[1] The Federal Managers' Financial Integrity Act of 1982 ("FMFIA") requires HUD's self-evaluation and reporting of such administrative inadequacies. HUD issued its 1989 FMFIA report on December 29, 1989, following receipt from Price Waterhouse of an independent audit of the Federal Housing Administration's mortgage insurance funds that included a provision for losses of approximately $960 million that HUD/FHA anticipated realizing in its General Insurance Fund from its co-insurance programs.

The full Banking Committee on September 28, 1989, considered the use of co-insurance with the Section 8 Moderate Rehabilitation rental assistance program. The testimony focused upon abuses that occurred, when co-insurers underwrote projects that received Section 8 subsidies. The Housing and Urban Affairs Subcommittee on September 27, 1989, heard the results of the Price Waterhouse audit of the FHA insurance funds.

At the time of the September 1989 hearings HUD had not completed its internal evaluation of the co-insurance programs, and Price Waterhouse, as consultant to HUD, had not completed its report on recommended changes in the co-insurance programs' capital standards, financial reporting requirements, and monitoring and enforcement systems.

The Subcommittee determined to follow up on the September hearings with a broader review of the co-insurance programs that took account of the HUD decisions and Price Waterhouse report.

B. Nature of Co-Insurance Programs

The principal co-insurance programs to be examined in this report provide for the financing of multifamily housing for low and moderate income families under the general co-insurance authority of Section 244 of the National Housing Act ("NHA") and the multifamily mortgage insurance authority of Section 223(f) or Section 221(d) of the NHA. Section 223(f) provides financing for the purchase and non-substantial rehabilitation of existing housing as well as refinancing of such housing. Section 221(d) provides financing for new construction or substantial rehabilitation of multifamily housing or retirement service centers. HUD initiated the current Section 223(f) co-insurance program in May 1983 and the current Section 221(d) co-insurance program in October 1984.

A third, less significant program to be examined in this report is the Section 232 co-insurance program. HUD initiated this program in September 1988 to finance nursing homes and other health care facilities. It depends upon the general co-insurance authority of Section 244 and the health care facilities mortgage insurance authority of Section 232 of the NHA.

Section 244 authorizes the HUD Secretary to share mortgage insurance risk, that the Secretary otherwise is able to assume pursuant to Title II of the NHA, with a private lender on terms that contemplate that the co-insurer:

-- assume at least 10% of the risk of loss;
-- underwrite the loan "subject to audit, exception, or review requirements";
-- share with HUD the insurance premiums "on a sound actuarial basis";
-- collect from the borrower a mortgage insurance premium prescribed by the Secretary that does not exceed the premium that may be collected under full insurance by HUD; and
-- assume, with respect to multifamily mortgages, the risk of a fixed percentage of loss and share the remaining loss with HUD.[2]

Co-insurance contemplates risk sharing in consideration for a sharing of the insurance premium. HUD exercised its authority under Section 244 by requiring under all three co-insurance programs that the co-insurer absorb a loss equal to 5% of the insured mortgage debt and 15% of the balance of any loss. HUD would absorb the remaining 85% of the loss balance. If the co-insurer were to re-insure with a third party more than 50% of its risk, HUD would absorb a lesser portion (72.25%) of the loss balance.[3] HUD permitted the co-insurer to collect from the borrower up-front fees under the three programs that could be included in the loan amount. These fees included an application fee of up to 30 basis points (0.30%), a financing fee of up to 200 basis points (2%), a placement fee of 150 basis points (1.50%), and in certain circumstances an inspection fee. HUD fixed the insurance premium at 1% at closing (with HUD receiving 65 basis points) and an annual renewal premium of 50 basis points (with HUD receiving 40 basis points).[4] HUD, also, permitted co-insurers to collect under the Section 223(f) and 221(d) programs an annual loan servicing fee of 25 basis points. HUD required the co-insurer to collect such a fee under the Section 232 program. If the co-insurer issued securities backed by the co-insured loan and guaranteed by the Government National Mortgage Association ("GNMA"), GNMA required the co-insurer to collect an additional loan servicing fee of 25 basis points. GNMA received up to 18 of the 25 basis points as a guarantee fee.[5]

Co-insurers participating in the Sections 223(f) and 221(d) programs funded virtually all of their loans by issuing to investors mortgage-backed securities guaranteed by GNMA. Co-insurers have underwritten very few loans under the Section 232 co-insurance program. GNMA has guaranteed securities backed by Section 232 co-insured loans on a case-by-case basis. GNMA has authority under Section 306(g) of the NHA to guarantee securities backed by loans insured under Title II of the NHA.

The securitization of co-insured loans with the assistance of GNMA enables the co-insurer to obtain the benefit of the Federal Government's credit enhancement twice, first, a partial (approximately 80%) insurance coverage with FHA and, second, a complete (100%) guarantee by GNMA. While GNMA's guarantee runs to the benefit of the investors in the co-insured loan by assuring the investors full payment of the loan's principal and interest, the co-insurer also benefits from the guarantee by obtaining an assured source of funding the loan from the proceeds of sale of GNMA-guaranteed securities to the investors.

GNMA agreed to extend its guarantee to co-insured loans on the condition that FHA indemnify it against certain losses. FHA's indemnity protects GNMA to the same extent that GNMA is protected, when GNMA guarantees securities backed by loans fully insured by FHA.[6]

II. Results of the Co-Insurance Programs

A. Program Data

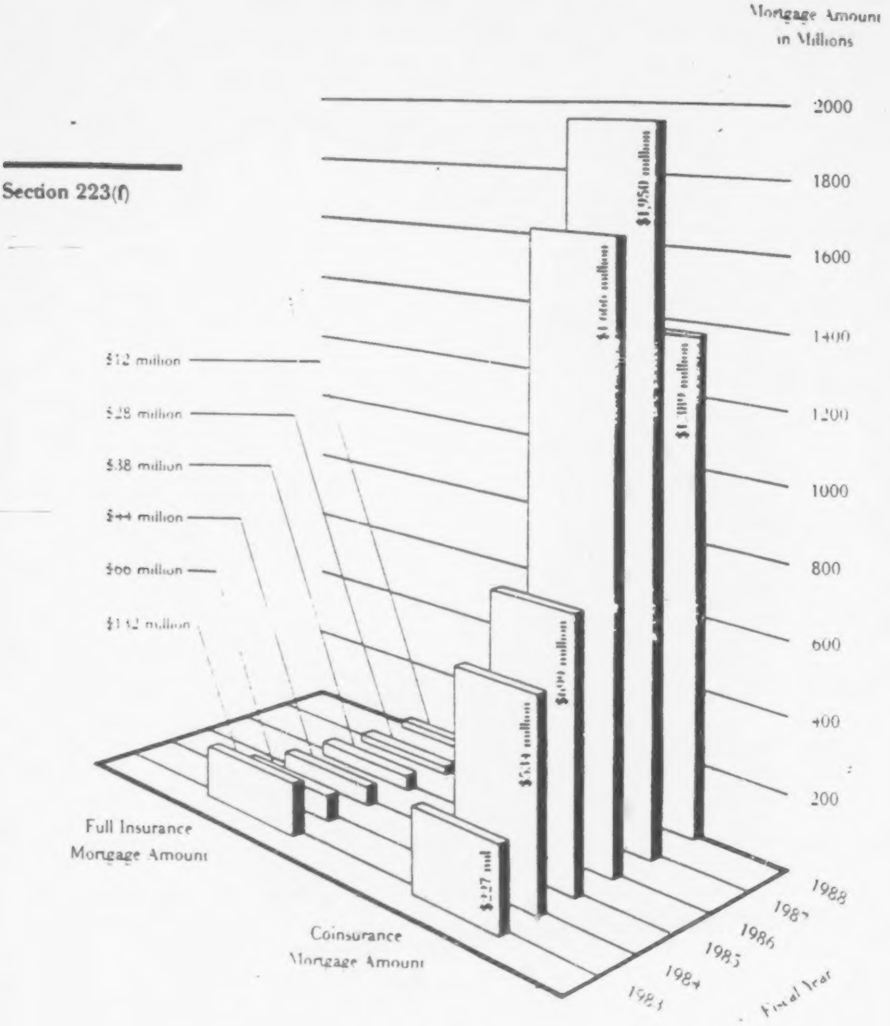
The vast majority of co-insured lending has occurred in the Section 223(f) program that provides financing for purchase and non-substantial rehabilitation of existing housing or refinancing of such housing. The projects and housing units financed under the three co-insurance programs and the aggregate outstanding mortgage loans that have been co-insured as of December 31, 1989, are as follows:[7]

Program	**Projects**	**Units**	**Mortgage Amount**
223(f)	1,273	304,665	$7,422,680,000
221(d)	250	48,445	2,418,205,500
232	5	N/A	29,126,300

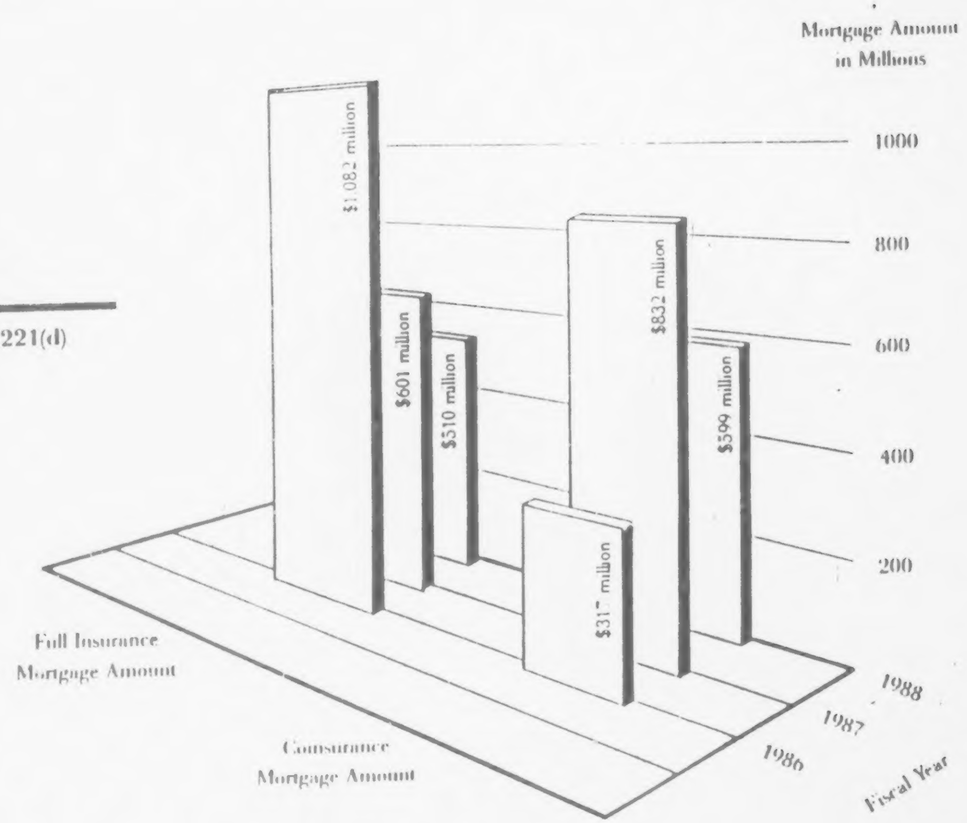
These data indicate that approximately 75% of co-insured loans outstanding as of the end of 1989 were originated under the Section 223(f) program.

The following charts graphically illustrate the relative amount of loans insured in recent years under co-insurance or full insurance in the Section 223(f) and 221(d) programs:

Section 223(f)



Section 221(d)



Co-insurance has increased loan activity in the Section 223(f) program. The loan amounts shown in the charts above translate into the financing of between 5,000 and 6,000 housing units under full insurance in the early 1980's and approximately 40,000 housing units under co-insurance later in the decade.[8] Co-insurance activity has replaced full insurance in the Section 221(d) program. In 1986 full insurance financed 19,500 housing units; co-insurance financed 4,600 units. In 1989 the numbers were reversed. Full insurance financed 4,700 housing units, while co-insurance financed 10,500 units.[9]

B. Status of Co-Insurance Programs Today

The co-insurance programs are suffering from acute rates of loan default and disastrous rates of loss on defaulted loans.[10] As of December 31, 1989, the aggregate defaults and related HUD/FHA insurance claims paid were as follows:

Program	Defaults		Claims Paid	
	Projects	Mortgage Amount	Projects	Amount paid
223(f)	187	$1,059,400,200	26	$72,796,831
221(d)	19	240,702,400	0	0
232	0	0	0	0
Total:	206	$1,300,102,600	26	$72,796,831

As of May 1990 the aggregate co-insured loans in default had increased to more than $1,600,000,000. The defaulted loans in the Section 223(f) co-insurance portfolio originated by DRG Funding Corp. accounted for approximately one-half of this total.[11] This high concentration of loan defaults in the portfolio of one co-insurer reflects the concentration of insurance underwriting that HUD permitted in the co-insurance programs, particularly the Section 223(f) program. DRG Funding Corp. originated approximately 34% of the loans co-insured under the Section 223(f), 221(d), and 232 programs! DRG and York Associates, Inc. originated approximately 55% of all co-insurance activity.[12] DRG and York participated only in the Section 223(f) program. Their poor underwriting, particularly that of DRG, has resulted in loan defaults that explain why the incidence of defaults is highest in the Section 223(f) program.[13]

These loan defaults have resulted in GNMA's termination of seven co-insurers as GNMA issuers. As of December 20, 1989, GNMA had terminated four co-insurers. Based upon those four terminations and other defaults in the co-insurance programs reported as of September 15, 1989, Price Waterhouse recommended that HUD/FHA record for the fiscal year ending September 30, 1988, a provision for losses of $960 million.[14] As the loan defaults and terminated issuers have increased since that date, one may fairly anticipate an increase in the loss reserves for the fiscal year ending September 30, 1989. According to one informed observer, these losses of HUD/FHA "are much more dramatic and much more severe than I think virtually any other lender in the business has experienced...."[15]

In addition to HUD/FHA's losses GNMA has realized losses that it does not expect to recoup from HUD/FHA or any third party. For its fiscal year ending September 30, 1989, GNMA will record a provision for losses of $50.5 million that is attributable solely to co-insured multifamily loans that back GNMA-guaranteed securities.[16]

While the magnitude of expected program losses is distressing, the average recovery rate (percentage of defaulted loan amount recovered from loan collection) that is being realized on liquidation of defaulted projects is disastrous. Price Waterhouse in its analysis of the co-insurance programs for HUD characterizes the recovery rate of 40% as "absolutely dismal."[17] In calculating probable future program losses Price Waterhouse uses this rate, because "given the programs' poor history, [there is] no prudent basis for" using an higher rate.[18] HUD acknowledges that its recovery rate "has been averaging 40%."[19]

HUD/FHA and GNMA have exercised administrative sanctions against certain co-insurers in response to these adverse program loan defaults and losses. GNMA's termination of a co-insurer's loan funding source effectively puts the co-insurer out of business. In addition, HUD/FHA had suspended seven co-insurers and placed another six on probation as of January 30, 1990. More recently, on May 2, 1990, HUD placed additional co-insurers on probation and suspended others.[20]

Between May 1989 and May 1990 the aggregate number of co-insured loans in default increased substantially. In September 1989 HUD testified that the default rates for the Sections 223(f) and 221(d) co-insurance programs (excluding the defaults in the DRG Funding Corp. portfolio) were lower than the default rates for the Sections 223(f) and 221(d) full insurance programs. HUD noted that the default rate on the Section 221(d) co-insured loans was likely to change, as the loans aged (and interest reserves were used up).[21]

More recently, HUD has testified that the default rate in co-insurance portfolios has "skyrocketed". "We [HUD] have just dramatic problems here relative to full insurance as it now turns out and it's still going on."[22] The following charts prepared by HUD illustrate the increase in default rate:

DELINQUENCY through CLAIM NOTIFICATION SYSTEM (DCNSII)

COMPARISON of 223(f) Projects in DEFAULT with Mortgages in Force as of 05/01/90

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MORTGAGEE		COINSURED MORTGAGES IN FORCE			ORIGINAL MORTGAGE VALUE			ADVANCES	
		TOTAL	DEFAULTS	% IN DEFAULT	TOTAL	DEFAULT	% IN DEFAULT	CURRENT MONTH	TOTAL
American Mortgages, Inc.		51	2	3.92 %	304,309,588	5,057,500	1.66 %	58,997	448,201
Benton Mortgage Company		101	5	4.95 %	373,440,300	17,277,000	4.63 %	303,574	1,077,760
Brennan-Indio, Inc.		27	2	7.41 %	128,357,000	13,184,500	10.27 %	104,290	301,187
Carnegie Evans L.P.		10	9	90.00 %	83,437,700	82,134,200	98.44 %	632,748	1,242,065
DRG Funding Corp. (Serviced by Reilly Mtg. Co.)		79	3	3.80 %	586,795,700	26,255,700	4.47 %	46,032	46,032
DRG Funding Corporation (Serviced by YORK ASSOC.)		183	116	63.39 %	858,153,400	743,310,300	86.62 %	5,239,763	75,480,481
Davis-Penn Mortgage Company		13	1	7.69 %	27,107,200	1,561,000	5.76 %	14,019	309,140
Merchants Mortgage Corporation		6	2	33.33 %	20,086,300	4,480,000	22.30 %	0	0
Sigma Mortgage Corporation (Formerly Eagle Mtg.)		28	9	32.14 %	111,555,000	39,893,000	35.76 %	307,100	2,370,846
Southwest Funding Group, Inc.		41	17	41.46 %	136,290,400	56,824,200	41.69 %	424,132	4,074,469
TRI Capital Corporation		23	1	4.35 %	78,656,600	2,077,900	2.64 %	18,281	94,331
York Associates		325	52	16.00 %	2,140,484,600	261,123,400	12.20 %	549,470	4,376,277
Other Lenders		166	0	00.00 %	1,302,062,475	0	00.00 %	0	0
TOTALS:		1,053	219	20.80 %	6,150,736,175	1,253,178,700	20.37 %	7,777,194	90,626,477
Last Month	04/90	1,079	216	20.02 %	6,349,035,575	1,245,158,600	19.61 %	7,734,636	95,280,422
Six Months Ago	11/89	1,056	168	15.91 %	6,224,286,075	972,275,900	15.62 %	7,527,839	68,096,457
One Year Ago	05/89	990	139	14.04 %	5,809,357,600	807,715,800	13.90 %	5,892,906	37,367,424

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DELINQUENCY through CLAIM NOTIFICATION SYSTEM (DCNSII)

COMPARISON of 221(d) Projects in DEFAULT with Mortgages in Force as of 05/01/90

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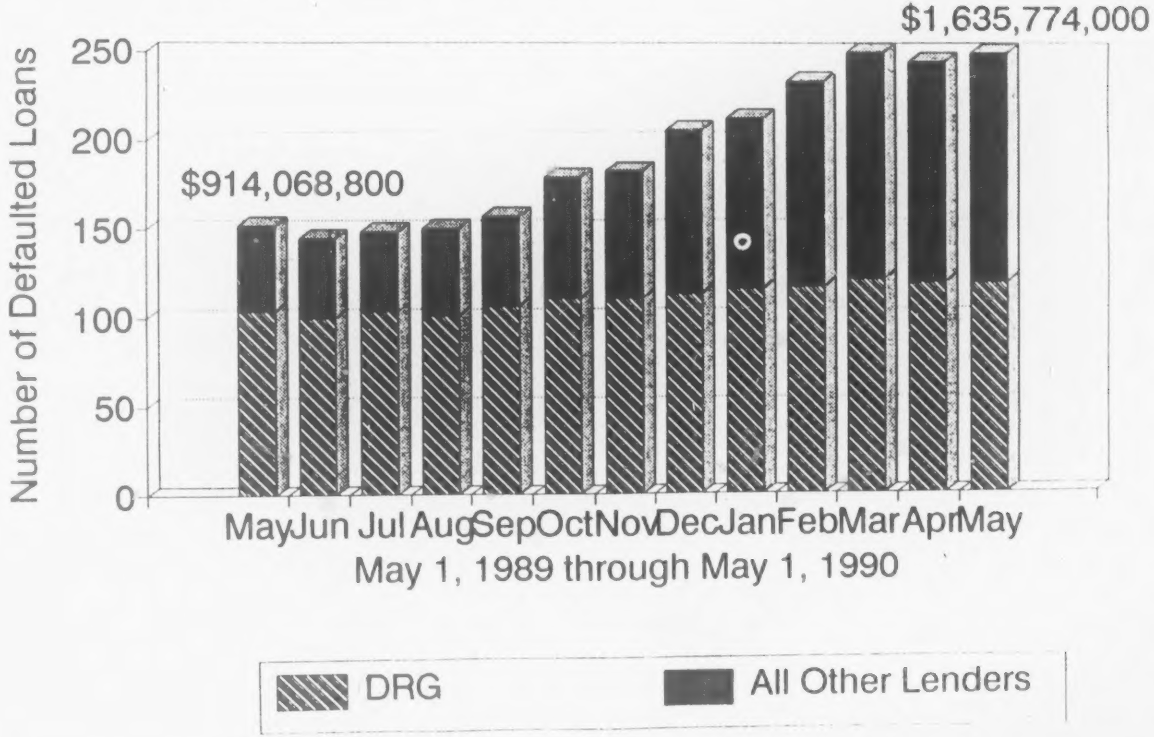
		COINSURED MORTGAGES IN FORCE			ORIGINAL MORTGAGE VALUE			ADVANCES	
MORTGAGEE		TOTAL	DEFAULTS	% IN DEFAULT	TOTAL	DEFAULT	% IN DEFAULT	CURRENT MONTH	TOTAL
ABG Financial Services, Inc.		42	3	7.14 %	400,218,000	52,882,900	13.21 %	46,603	1,330,571
Benton Mortgage Company		45	1	2.22 %	262,613,200	9,856,200	3.75 %	167,387	1,339,091
Carnegie Evans L.P.		20	4	20.00 %	169,416,900	31,722,100	18.72 %	288,913	1,482,912
Cincinnati Mortgage Corporation		13	1	7.69 %	119,259,000	6,283,000	5.27 %	28,120	109,095
M-West Mortgage Corporation (formerly Meritor)		7	2	28.57 %	62,821,000	9,991,400	15.90 %	690,915	710,560
Patrician Mortgage Company		33	4	12.12 %	333,854,500	17,439,200	5.22 %	84,088	213,289
Fuller Mtg. (Serviced by American Cap. Resources)		21	7	33.33 %	296,454,000	124,622,600	42.04 %	0	5,903
Fuller Mtg. (Serviced by Coopers & Lybrand)		13	8	61.54 %	175,712,000	129,797,900	73.87 %	435,604	1,532,194
Other Lenders		81	0	00.00 %	878,452,100	0	00.00 %	0	0
		-------	---	-----	-------------	-----------	-----	-----------	-------------
	TOTALS :	275	30	10.91 %	2,698,800,700	382,595,300	14.18 %	1,749,910	6,893,595
Last Month	04/90	270	29	10.74 %	2,645,195,700	368,220,500	13.92 %	1,596,784	5,938,106
Six Months Ago	11/89	246	15	6.10 %	2,372,872,200	187,313,300	7.89 %	401,177	3,239,747
One Year Ago	05/89	219	13	5.94 %	2,144,771,700	106,353,000	4.96 %	514,354	3,151,398

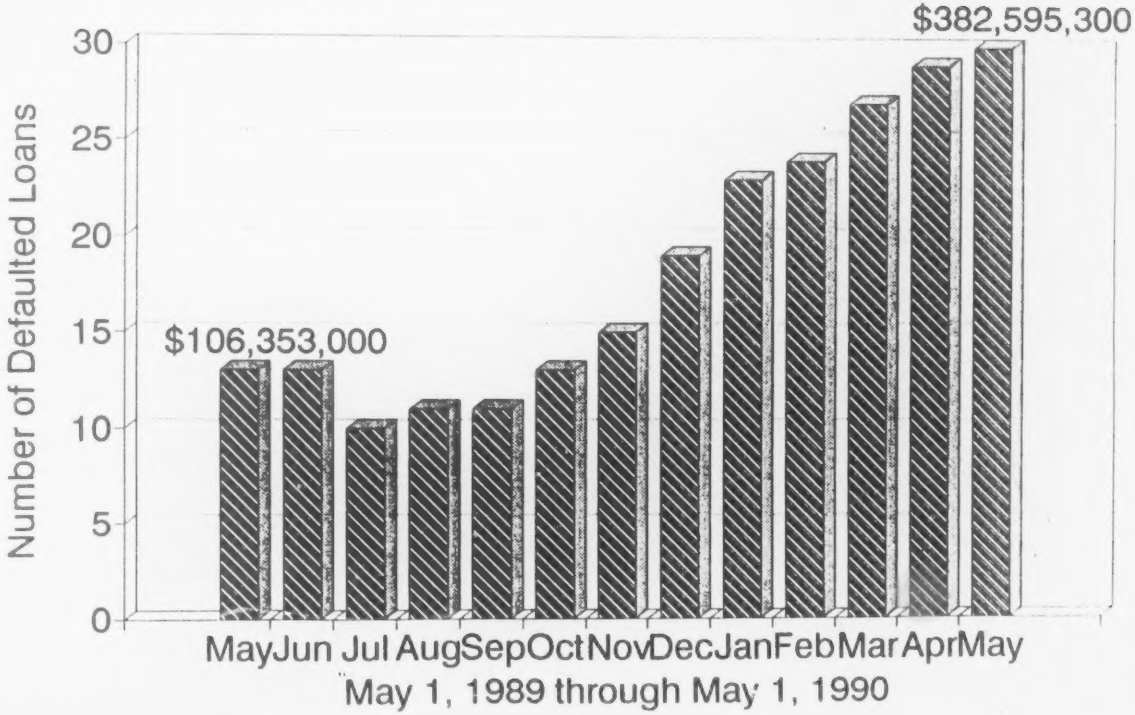
Defaulted Coinsured Loans

Since Moratorium Began in May 1989



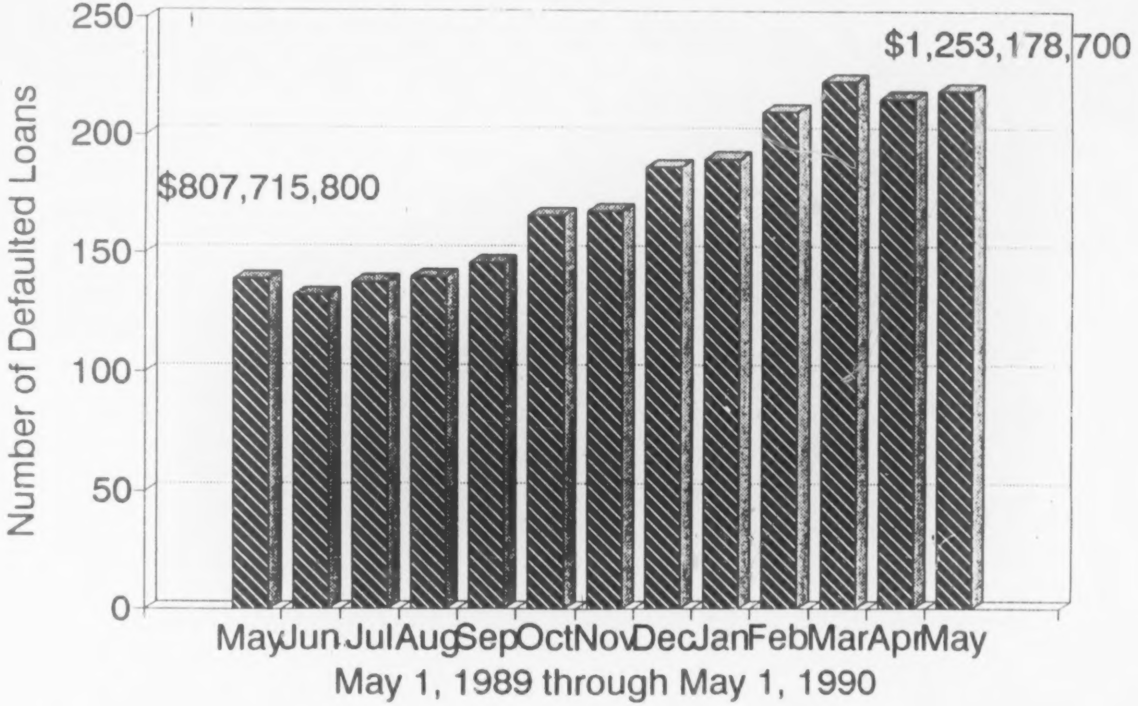
Defaulted 221(d) Loans

Since Moratorium Began in May 1989



Defaulted 223(f) Loans

Since Moratorium Began in May 1989



While the default rate on co-insured loans clearly has increased since HUD's September 1989 testimony, HUD does not appear to maintain data by which the default rate under co-insurance can be readily compared with that under full insurance. Default rates under the former are determined by borrower defaults, while default rates under the latter are determined by

HUD/FHA insurance claim payments.[23] There may be a substantial period, particularly for co-insured loans, between a borrower's default and HUD/FHA's payment of insurance. During this period it is possible that a loan's status could change. Thus, the comparison of the two default rates is a comparison of apples and oranges.

As foreclosure and sale of co-insured loans occurs, projects that have benefitted from the dual financing subsidies of FHA insurance and the GNMA guarantee have been sold into the conventional real estate market.[24] The housing affordability benefits of the Sections 223(f) and 221(d) programs have been lost with respect to those projects.

III. Actions of GNMA and HUD/FHA To Modify The Co-Insurance Programs and Related GNMA Mortgage-Backed Securities Program

In May 1989, HUD commenced an evaluation of the co-insurance programs and imposed a moratorium on the entry of new participants into the programs.[25] This evaluation continued through the autumn. As of the full Committee's September 28, 1989, hearing HUD apparently was close to determining reforms of the co-insurance programs that might have enabled their continuation.[26] The reforms included changes in the capital requirements applicable to program participants. HUD retained Price Waterhouse in May 1989 to advise it on recommended changes. HUD and program participants engaged in extensive and sometimes contentious discussions regarding the capital requirements that were necessary from HUD/FHA's viewpoint and acceptable to the participants. Ultimately, HUD determined that participants were not willing to accept the changes that HUD thought appropriate[27] and that "the essential first step toward reform was rendered impracticable."[28] In opting to propose termination rather than reform of the co-insurance programs HUD has indicated as follows:

> This analysis [of the programs by HUD] has indicated that the program changes required would be so extensive and fundamental to the co-insurance program as to change its nature and structure. These changes would require such a level of supervision by HUD that they would undermine the essential deregulatory premises of the co-insurance program as it was originally contemplated. Indeed, the nature of this kind of adjustment in the program would so limit the amount of discretion and independence of the co-insuring lender

> as to blur existing distinctions between the co-insurance and full insurance programs.[29]

HUD has announced its determination to replace the co-insurance programs in 1990 with full insurance programs in which lender participants undertake substantial loan processing on behalf of HUD, but HUD retains the loan underwriting approval authority.[30]

In January of this year, when Secretary Kemp first announced HUD's intent to terminate the co-insurance programs, HUD also issued informal "lender letters" that imposed after a specific date a requirement that co-insurers obtain HUD's approval prior to issuing a loan commitment. HUD's ability to change informally co-insurers' underwriting authority has been successfully challenged in court.[31] In response to the Court's May 16, 1990, order, HUD has published a proposed rule requiring the "pre-commitment review" procedure that it had announced in January.

Except for this proposed rule neither HUD/FHA nor GNMA has proposed any changes in the regulatory terms of the co-insurance programs and related mortgage-backed securities program, notwithstanding that there is an outstanding co-insured loan portfolio of almost $10 billion, and HUD means to permit co-insurers that are in compliance with existing program requirements to continue to originate loans pending the termination of the programs.[32]

Further, while both GNMA and HUD/FHA have exercised administrative sanctions against co-insurers, HUD/FHA's efforts to improve its ability to monitor the credit risk it has already assumed have been marginal, and HUD/FHA has acknowledged that the pre-commitment review procedure does not reliably protect HUD/FHA against loss with respect to co-insured loans. At the Subcommittee's March 27, 1990, roundtable discussion of co-insurance HUD Under Secretary Dellibovi stated as follows:

> Let me wind up by pointing out that there is a distinction that needs to be made between monitoring and enforcement. We have not significantly increased our monitoring, but we have done a very vigorous job in enforcement--so vigorous that we've closed down the program.[33]

The Under Secretary noted that the pre-commitment review procedure was a form of monitoring that HUD was undertaking. However, HUD has acknowledged that this procedure provides a limited benefit.[34] HUD has required this procedure from the inception of the Section 232 co-insurance program, but HUD concedes that it may experience an adverse loss experience like that in the other co-insurance programs. HUD has stated that it "must anticipate that a mature section 232 program would encounter precisely the same problems as those experienced by its near-identical sister programs."[35] Further, the HUD Inspector General has faulted HUD for its prior reliance upon pre-commitment review to protect its interests. In its December 9, 1988, audit report on the Section 223(f) program, the Inspector General observed that the pre-commitment review procedure had been ineffective in altering the loan underwriting practices of DRG Funding Corp.[36]

HUD has not developed substantially improved data collection systems or hired and trained additional staff to analyze financial data that would enable HUD to monitor more carefully its credit exposure on the outstanding $10 billion co-insurance portfolios that may increase this year while the co-insurance programs continue.[37]

IV. Co-Insurance Program Design Flaws And Implementation Failures

A. Program Design Flaws

The current default rates and program losses result from HUD's failures in implementing the co-insurance authority. These failures include both deficient conceptual design of the co-insurance programs and failures in the administration of the programs. Significant conceptual or design flaws have included:

(1) providing an assured source of loan funding through the securitization of co-insured loans with GNMA guarantee assistance without establishing and enforcing adequate controls over the quality of loans funded;

(2) requiring marginal equity capital of program participants and allowing program fees that created strong incentives for co-insurers to focus on the origination of an high volume of loans rather than on loan quality and long term loan collection;

(3) failing to establish a leverage limitation that would have controlled the co-insured loan portfolio of any one lender and would have prevented the concentration of insurance risk that HUD permitted;

(4) establishing "lowest common denominator" criteria for participation in the co-insurance programs and inadequate methods for screening program applicants that discouraged participants from valuing their credit relationship with the Federal Government;

(5) failing to anticipate the liquidity "squeeze" that co-insurers would experience, when loans defaulted, and the resulting incentive of co-insurers to originate new loans (to generate fee income) and to proceed to foreclosure and project sale as soon as possible;

(6) failing to anticipate the need for as broad a scope of remedies to address loan defaults as is available under the full insurance programs; and

(7) failing to anticipate the need to monitor lender compliance with program requirements.

Each of these is discussed in more detail below.

(1) Assured Loan Funding Without Control Over Loan Quality

GNMA's guarantee of securities backed by co-insured loans exposed the Federal Government to risk of loss similar to the Federal Government's risk with respect to the insurance of thrift deposits. The GNMA securitization of loans assured co-insurers a source of funding for their loans regardless of the quality of their loan underwriting, just as deposit insurance assured thrifts a source of funding of their loan assets regardless of quality. GNMA's guarantee is backed by the full faith and credit of the United States. Investors in GNMA-guaranteed securities rely upon that credit rather than the credit quality of the loan that is pledged to "back" the security.[38] The GNMA guarantee "effectively cuts the link between the riskiness of the mortgage the lender chooses to originate and its capacity to raise funding for these mortgages. Moreover, funding for the mortgages is always available, no matter how risky or unsound they may be, because the Ginnie Mae security provides ready access to the secondary [mortgage] market."[39]

GNMA agreed to guarantee full payment of securities backed by co-insured loans on the condition that HUD/FHA indemnify it against loss that might arise from the co-insurer's failure to satisfy its 20% insurance liability on co-insured loans. The combination of the GNMA guarantee, the HUD/FHA indemnification of GNMA, and HUD/FHA's lack of assurance that it would recoup from the co-insurer any payments made to GNMA placed 100% of the loan underwriting risk on the Federal Government. Both program design flaws and failures in program implementation effectively removed HUD/FHA's recourse against co-insurers for their share of the insurance liability and increased the probability that co-insurers would aggravate HUD/FHA's risk of loss by generating poor quality loans. HUD has acknowledged that its implementing actions or inactions removed the risk sharing that co-insurance contemplated. HUD has observed:

> In practice...FHA has frequently found itself bearing 100 percent of all losses, instead of the approximate 80/20 split envisioned in the program design.... If a co-insurer defaults on its obligations to GNMA, GNMA's remedy is to acquire the lender's portfolio, and FHA will eventually bear virtually the full amount of the loss....

This GNMA aspect-when coupled with undercapitalized lenders with incentives to over-mortgage-constitutes a major structural flaw in the co-insurance programs; that is, what is shared risk in theory has not held true in practice.[40]

(2) Inadequate Capital Requirements And Fee Structure With Wrong Incentives

Under the Sections 223(f) and 221(d) co-insurance programs HUD/FHA required participants to maintain "sound capital resources" of $1,500,000 plus $1 of "sound capital resources" for each $300 of outstanding co-insured loan principal. HUD defined "sound capital resources" as "the excess of the mortgagees' assets (net of any valuation allowances) over its liabilities..., including paid-in-capital stock, surplus, [loss] reserves, undistributed earnings and any other unencumbered resource of the mortgagee which may include... an unconditional and irrevocable firm letter of credit [in an amount not exceeding $500,000]."[41] The capital had to include $500,000 of "liquid funds" which were defined as "cash or readily convertible assets or a letter of credit not exceeding $500,000."[42]

The Section 232 co-insurance program varied from the two others by requiring a "dedicated account" that included certain program fees plus $1 for every $150 of outstanding co-insured loan principal (until the dedicated account reached $3 million and thereafter $1 for every $300 of outstanding co-insured loan principal) plus an amount (to be contributed over four years) equivalent to the lender's share of the mortgage insurance premiums that would be earned during the first four years of each loan.[43]

Price Waterhouse found the capital requirements "difficult to communicate, troublesome to compute, and difficult to relate to what system [or program] capital is or should be."[44] The capital requirements, also, do not increase by reason of a lender's participation in more than one program.[45]

More significantly, the credit exposure that HUD permitted participants in the Sections 223(f) and 221(d) programs to assume in relation to the marginal capital required far exceeded that permitted insured depository institutions or participants in the Delegated Underwriting and Servicing Program ("DUS Program") of the Federal National Mortgage Association ("FNMA"). If one assumes that all participants in the two co-insurance programs maintain the minimum required capital, the ratio of their 20% share of the insurance risk on outstanding Sections 223(f) and 221(d) co-insurance portfolios to the minimum required capital (the "leverage factor") is 18.6%. This substantially exceeds the leverage factor of 10.8% that would be permitted for insured banks with the same credit exposure and a factor of 10.6% that FNMA would permit under the DUS program.[46] The leverage factor for the

Section 223(f) program (20.7%) substantially exceeded that for the Section 221(d) program (14.7%).[47]

Both the minimal requirement of adding only 3 basis points of capital for each $1 of loan originated and the program fee structure, that allowed substantial "up-front" loan origination fees and did not require in the Sections 223(f) and 221(d) programs continuing loan servicing fees, created incentives for co-insurers to maximize their and the Federal Government's credit exposure and to distribute to themselves all fee income not needed to satisfy the capital requirement. These incentives not surprisingly produced a situation where the co-insurers, like thrifts, could adopt the attitude, "Heads I win, tails you lose." Professor Robert Edelstein, a participant in the Subcommittee's March 27, 1990, roundtable discussion, observed regarding the programs' incentives as follows:

> [T]he system was designed to enhance incentives of bad guys.... If we take ... a $2.3 billion portfolio, and if you say that the lender could basically get two percent fees out of that total, he would walk away with about $45 million right there. He puts up $1.5 million and then adds marginally about $8 million. So he gets $45 [million] and he has $9.5 [million] if he puts it into the pot timely. Most people would put $9.5 million in to get $45 million, if they could exit out of the operation. So there's real incentive under the way the thing was structured to cheat, to say, hey, I've made it up front.[48]

HUD has acknowledged the accuracy of Professor Edelstein's analysis of the programs' incentives and their conflict with the Federal Government's financial interests as follows:

> Because of the way the co-insurance program is currently structured, lenders make most of their income on co-insured loans "up front" (i.e., when the loan is closed). Since fees are expressed as a percentage of the mortgage amount, higher mortgages yield higher fees. Absent revised capital requirements that would have forced lenders to retain a larger share of this fee income as paid-in capital or loan loss reserves, lenders are able to distribute to themselves large portions of their fee income as "profit." This structural flaw...creates an inducement for lenders to over-mortgage properties and create loans without adequate regard for their long-term viability, thereby compounding the federal government's potential losses.[49]

(3) Concentration of Insurance Risk

HUD/FHA failed to establish by regulation, policy guideline, or otherwise a limit on the loans that could be co-insured with any one lender. Such a loan or leverage limit would have imposed a restraint on co-insurers' pursuit of loan volume that the marginal capital requirements and program fee structure encouraged. In its recent audit of the FHA's insurance funds Price Waterhouse observed as follows:

> Furthermore, other quantitative controls that might have mitigated the [HUD/FHA's] losses were also missing. For example, there might have existed an overriding leverage limitation which would have begun to curtail the incentive for volume inherent in FHA's liberal capital accumulation formula, and which probably would have limited the concentration among a few large lenders.... Without a reasonable leverage limitation or a large enough capital requirement, the temptation to expand an increasingly lucrative revenue stream in relation to capital-at-risk can be expected to become overwhelming. If there is also an absence of adequate surveillance and monitoring (as we found to be the case), the temptation to grow, without regard to the quality of that growth is unbounded. Such circumstances constitute a fundamental program flaw, the responsibility for which cannot be delegated, nor can it be blamed entirely on the existence of fraud.[50]

Larry Dale, a senior officer of FNMA, commented as follows:

> It is absolute folly for any secondary lender or secondary source of credit to permit a concentration of risk in a portfolio to the degree that HUD/FHA's concentration of risk existed for much of the '80's and still exists to a substantial degree, and that was largely in the details of the way the program was initially introduced and operated....[51]

HUD has stated that during the first two years of the Section 223(f) program DRG Funding Corp. and York Associates originated 95% of all co-insured loans.[52] DRG and York originated 55% of all co-insured loans, and DRG alone originated 34% of all co-insured loans. Five co-insurers account for approximately 73% of all co-insurance activity.[53] HUD/FHA's delay in approving other lenders as participants in the Section 223(f) program apparently contributed to the monopoly of loan activity that DRG and York enjoyed.[54]

(4) "Lowest Common Denominator" Criteria For Participation In Programs

In designing and implementing the co-insurance programs and related GNMA mortgage-backed securities program HUD/FHA and GNMA did not establish criteria for participation in the programs and procedures for enforcement of those criteria that would provide reasonable assurance that program participants would value the Federal credit enhancement from GNMA and HUD/FHA sufficiently to be able and willing to minimize the Federal

Government's risk in order to continue to deliver loans for FHA insurance and GNMA-assisted securitization. The capital requirements best illustrate the "lowest common denominator" approach to establishing program criteria. But, other illustrations include the requirement of lenders' maintenance of "bare bones," in-house underwriting staff and submission of annual financial statements only and the failure to require lenders' maintenance of fidelity/surety bonds and errors and omissions insurance policies.[55] HUD/FHA even permitted DRG Funding Corp. to operate as a shell entity with management supplied by its parent corporation.[56]

HUD/FHA also maintained a process for screening program applicants that was deficient in placing application review in the Office of Single Family Housing staffed by persons unfamiliar with multifamily loan underwriting! The screening process was far less rigorous and thorough than that conducted by the Office of the Office of the Comptroller of the Currency with respect to applicants for national bank charters and by FNMA with respect to DUS Program applicants.[57]

HUD/FHA's approach contrasts sharply with that of FNMA in its Delegated Underwriting and Servicing ("DUS") Program. FNMA apparently has succeeded in establishing a "franchise value" associated with its DUS Program. By reason of the program's benefits that include providing a competitive source of funding for the acquisition, minor rehabilitation, or refinancing of multifamily projects, participating lenders are motivated to attempt to sustain a continuing relationship (or "franchise") with FNMA. FNMA's DUS Program requires participants to share risk with FNMA. "Now you add an element of risk-sharing with a franchise, and I think you really get a primary lender's attention so they don't want to do anything to Fannie Mae, in this instance, that would jeopardize their license."[58]

(5) Inadequate Anticipation of Liquidity Squeeze, When Loans Default

In designing and implementing the co-insurance programs and the related mortgage-backed securities program HUD/FHA and GNMA failed to anticipate adequately the liquidity squeeze that co-insurers would experience in the event of loan defaults. The securitization of a loan obligates co-insurers to continue making payments to securities holders, notwithstanding the loan default. The regulatory terms of the co-insurance programs meanwhile require little capital to sustain cash flow drains and create a potentially lengthy period of cash shortfall by reason of the co-insurer's obligation to handle management and liquidation of a defaulted loan prior to filing an insurance claim with HUD/FHA. One of the legislative purposes of the co-insurance authority was to induce private lenders to relieve HUD of the burden of handling loan defaults and foreclosures.[59] Consistent with that purpose HUD/FHA required the co-insurer to handle loan foreclosures and sales of defaulted projects.[60] In addition, however, HUD/FHA barred an insurance claim against it until the completion of foreclosure and either sale of the project or the passage of a year from the foreclosure and the obtaining of two appraisals of the project.[61] Particularly if the borrower sought protection in bankruptcy or for other reasons the foreclosure was substantially delayed, the co-insurer faced the prospect of carrying a defaulted loan for a painfully long period before it could obtain from HUD/FHA payment on the latter's 80% share of the insurance liability.

Warren Lasko, Executive Vice President of GNMA at the time GNMA securitization of co-insured loans was approved, observed at the Subcommittee's March 27, 1990, roundtable discussion as follows:

> My understanding is that in the period of time that it takes to get a claim from HUD and all the work a lender has to do while a claim is filed in attempting to sell the property and so forth has caused enormous cash drains that probably exceeded anything we anticipated at the time. As a result, it has made it difficult for the lender to stay in business during that period of time to live up to its obligations.[62]

In order to remain in business co-insurers either originated new loans to generate fee income or sought to expedite the foreclosure and sale process as much as possible in order to accelerate the recovery from HUD/FHA of its 80% share of the risk of loss.[63] Frequently, the newly originated loans were poorly underwritten.[64] Both of these types of actions aggravated HUD/FHA's risk of loss.

(6) Failure To Anticipate Need For Remedies Other Than Foreclosure

Related to the immediately prior point is HUD/FHA's failure to anticipate the need for remedies that are available in the full insurance programs to deal with loan defaults. The Housing Study Group, a trade association of co-insurers, in a submission to HUD observed as follows:

> The co-insurance program also fails to provide the co-insurer with the same flexibility in alternatives to foreclosure as are available under the full insurance program....
> Under its full insurance programs, the Department has a wide and flexible range of remedies to deal with defaulted projects. Such remedies are designed to allow the Department to seek solutions to defaults that best serve its economic interests. Conventional lenders have a similar range of remedies. Co-insurers, however do not, and as a result are essentially limited to foreclosure, a remedy which may frequently be more costly to the co-insurer (and therefore HUD as well) than other well-established workout programs.[65]

(7) Inadequate Anticipation of Need For Monitoring

In designing the co-insurance programs HUD/FHA failed to anticipate adequately its need to establish a system of monitoring and evaluating the insurance risk that co-insurers were assuming for themselves and HUD/FHA.

HUD determined to implement the co-insurance authority as a means of sustaining multifamily mortgage insurance programs in the face of a declining in-house capacity to underwrite such insurance.[66] The decline in that capacity had resulted in HUD/FHA ceasing to be an underwriter that could respond efficiently and timely to mortgage insurance applications. Processing delays of two years or more were becoming normal. "HUD clearly believed that moving its multifamily insurance processing to co-insurance would lessen the demand for in-house staff."[67] HUD not only elected to rely on private sector parties to process paper. It subscribed to the "privatization" of the performance of the underwriting function itself. HUD believed that the risk-sharing contemplated by co-insurance would motivate co-insurers to act prudently in their self-interest, and this self-interest would protect HUD/FHA as well. "The underlying theory of the program was that a co-insuring lender's financial stake in the success of a co-insured project would promote caution and responsibility in underwriting, because the lender would have a strong financial self-interest in avoiding having to absorb its share... of any loss."[68] HUD/FHA did not adequately recognize the program flaws discussed above that undermined or removed the basis of this theory or assumption. Chris Greer, Assistant HUD Inspector General for Audit, observed at the Subcommittee's March 27, 1990, roundtable discussion as follows:

> [W]hen we went from an underwriter, which HUD was at the time, to a monitor, that function is totally different. You need different people with different skills and I don't think the Department either thought about it or prepared themselves to take on that different function. They simply got the program into the industry without thinking about the skills needed to monitor, number one; and number two, the financial systems or the wherewithal to detect the problems on a timely basis.[69]

Larry Dale of FNMA observed that the program regulations did not focus on the "management of the relationship with the co-insuring lenders."[70] He further observed that "the relationship and the ability of the lender to make good on their part of the co-insurance bargain was never really questioned or addressed in the program regulations. It was assumed that co-insuring lenders would uphold their end of the risk sharing agreement."[71] Clearly, HUD/FHA did not challenge its own assumptions in designing the programs. A less sanguine perception of co-insurers' incentives would have disclosed a need to maintain a more watchful eye.

B. Implementation Failures

Following the initiation of the Section 223(f) co-insurance program in May 1983 and the Section 221(d) co-insurance program in October 1984 HUD failed to implement the programs in a prudent, safe and sound manner. The administrative failures included the following:

(1) failure to develop internal systems of control and financial management systems that would enable HUD to report accurately the financial status of the co-insurance programs;

(2) failure to develop data systems and in-house staff capacity to monitor HUD/FHA's credit risk and to respond to project loan defaults and lender failures; and

(3) failure to exercise available administrative sanctions against non-complying lenders.

Each of these is discussed further below.

(1) Failure to Develop Internal Control And Financial Management Systems

HUD/FHA has suffered from basic institutional weaknesses that preceded the initiation of co-insurance and continued thereafter. In testifying on the most recent audit of the FHA insurance funds the Comptroller General observed as follows:

> Basic management weaknesses must be corrected if future losses are to be brought under control. The audit disclosed several problem areas:
>
> -- There has been a lack of effective monitoring of those program activities delegated to the private sector,
> -- Financial information needed to properly manage FHA's programs has not been available,
> -- Important internal controls are not effective, particularly with regard to cash management and the processing of multifamily insurance claims,
> -- Essential accounting functions have not been performed adequately, and
> -- Management has not been diligent in correcting the weaknesses identified in earlier reviews.[72]

The Comptroller General further observed: "These are the same fundamental accounting and financial management problems that GAO and the Inspector General have been reporting on since the early 1980s."[73]

These institutional problems have serious, financial consequences. They "open FHA to mismanagement and an unnecessary risk that fraud and abuse will occur and not be detected. They also impair management's ability to assess the level of risk arising from normal insurance operations."[74] As the problems have existed for more than a decade, their resolution will require substantial time and "a long-term commitment by top management."[75]

The cited problems have prevented GAO from issuing an unqualified opinion on the financial condition of the FHA insurance funds since 1974.[76] Between 1975 and the most recent audit (as of September 30, 1988) GAO was not even able to conduct full financial audits.[77] The Price Waterhouse opinion with respect to its audit as of September 30, 1988, is qualified in part because of its uncertainty as to the magnitude of the losses in the General Insurance Fund attributable to the co-insurance programs.[78]

The lack of availability of current, accurate financial information with respect to the activities of HUD/FHA, including its co-insurance program activities, has resulted in a lack of accountability of HUD/FHA management for program results. In attempting to explain HUD/FHA's failure to enforce vigorously the co-insurance program requirements C. Austin Fitts, Assistant Secretary of HUD for Housing, observed that in her view "the most critical element" was HUD/FHA's "failure to disclose financial results of the program or the participants in the program."[79] Logic supports the observation. If management does not have to report the financial results of its actions or inactions, no one outside the agency is able to determine the manner of its performance and hold it accountable for that performance.

(2) Inadequate In-House Monitoring and Loan Default Prevention and Workout Capacity

From initial program implementation until the present HUD/FHA has devoted inadequate staff and other resources to program monitoring. In its recent audit of the FHA insurance funds Price Waterhouse found "an absence of adequate surveillance and monitoring."[80] Participants in the programs concur with this judgment. In July 1986 the Mortgage Bankers Association complained to HUD Secretary Pierce of HUD/FHA's neglect to monitor and enforce program requirements.[81] More recently, the Association has stated that it "remains convinced that HUD is still short of qualified experienced staff to monitor the program and to assist with workouts of problem loans. HUD officials have indicated this problem in meetings and in conversations."[82] George Hipps, a senior officer with PW Funding, Inc., a co-insurer, observed that he did "not currently see any commitment to proper oversight."[83]

HUD has acknowledged that between 1983 and July 1986 "no FHA staff were specifically assigned to co-insurance monitoring."[84] Subsequent to receipt of the Mortgage Bankers Association's complaint, HUD established in August 1986 a Co-insurance Monitoring Branch. The staff years allocated to this office have been marginal. They have increased from 3 in 1986 to 10 in 1989.[85] In addition, certain HUD/FHA technical support staff have performed "limited" monitoring.[86]

In its report to HUD regarding changes needed in the co-insurance programs Price Waterhouse found numerous specific deficiencies in HUD/FHA's monitoring system. They found, for example, that the required financial reporting by program participants was too infrequent and inconsistent. They recommended that HUD "carefully consider moving toward standardized reporting requirements, and not just on an annual basis."[87] HUD's existing requirement of annual financial reports provides "no assurance throughout the year that sound capital resources are being maintained or that liquid funds are available."[88] Price Waterhouse compared HUD/FHA's monitoring with the financial reporting and analysis performed by the Federal bank regulatory agencies and concluded that "HUD has yet to develop a mechanism approaching the breadth and sophistication of that used by the bank regulators."[89] Price Waterhouse recommended that HUD develop a quarterly call reporting system like that required by the bank regulators.[90] They also recommended that HUD "develop a group of experienced financial analysts" and "a loan (or credit) evaluation mechanism."[91]

An adequate monitoring system would help prevent the realization of insurance risk and attendant loss. By establishing a capacity to evaluate on a continuing basis the credit risk that it has assumed HUD/FHA would facilitate its timely exercise of administrative rights and remedies against non-complying co-insurers. Such timely action could reduce the losses that HUD/FHA might realize. Similarly, the establishment of an enhanced in-house staff capacity to manage loan defaults would facilitate mitigation of such losses.

(3) Failure to Exercise Administrative Sanctions

HUD/FHA and GNMA have aggravated substantially the losses realized in the co-insurance programs by failing to exercise vigorously and timely their administrative remedies against defaulting co-insurers. The most graphic illustration of this failure is the delay in taking adequate action against DRG Funding Corp.

GNMA terminated DRG as an eligible issuer of GNMA-guaranteed securities on September 16, 1988. At the time of this action more than one-half billion dollars of co-insured loans originated by DRG, or approximately one-half of its total co-insurance portfolio, were in default![92]

It was not until six months later that HUD/FHA suspended DRG from further participation in the Section 223(f) co-insurance program.[93] As of March 23, 1990, GNMA controlled eight hundred million dollars of co-insured loans in default. DRG-originated loans were more than 75% of this total.[94] HUD/FHA has established loss reserves of $960 million by reason of the termination of

DRG and three other co-insurers as issuers and the loan defaults known as of the completion date of the Price Waterhouse audit.[95] The DRG portfolio will produce a substantial portion of these losses.

From the very outset of the co-insurance program HUD/FHA knew that DRG was a problem lender that would not comply with program requirements. HUD/FHA knew of DRG's underwriting deficiencies from the three test case reviews that were required for entry into the co-insurance programs.[96] The Colonial House project, a troubled project that has been the subject of prior full Committee inquiry, was DRG's first loan as a co-insurer![97] HUD/FHA placed DRG on probation between November 1984 and May 1985 and required pre-commitment review of loan files by HUD/FHA.[98] According to the HUD IG, the imposition of the review procedure did not alter DRG's underwriting practices.[99]

The HUD IG has determined that York Associates, the originator of the second largest Section 223(f) co-insurance portfolio after DRG, engaged in underwriting practices that from the inception of the Section 223(f) program did not comply with program requirements.[100] When GNMA terminated DRG as an issuer, it retained York to service the DRG portfolio notwithstanding this regulatory history of York!

The HUD IG's reports of November 5, 1985, and December 9, 1988, either exclusively or primarily analyze the performance of DRG and York and the response by HUD/FHA. The later report also reviewed the performance of a third co-insurer. Both reports found that HUD/FHA failed to take timely and adequate enforcement action against DRG and York.

HUD has not provided satisfactory explanations for its enforcement failures. HUD simply "lacked the political will to take swift action."[101] HUD has indicated to the Subcommittee that staff have been unable to find "any HUD records that disclose the reasons for this lack of will during the prior [Reagan] administration."[102]

Others have offered possible explanations. The HUD IG has concluded that "HUD has been reluctant to exercise its authority to suspend or terminate lenders for serious infractions due to the potential adverse impacts such sanctions may have upon the lenders' financial positions and the Co-insurance Program."[103] This explanation is consistent with others' observations. George Hipps attributes the failure in part to HUD/FHA's promotional attitude towards the co-insurance programs. [104] Larry Dale, in explaining FNMA's ability in the DUS Program "to lever penalties against lenders who do not perform well that stop short of putting them out of business", observed as follows:

> FHA faced several situations in the mid-1980's and the late 1980's where they had the choice between administering penalties that would effectively put a lender out of business--and therefore bring

> them down and force a major Government loss--or permitting the lender to continue in the business with the hope that they will stay viable from additional fees earned but with the risk of additional problem loans.[105]

HUD Assistant Secretary Fitts has indicated that lack of timely information and staff expertise contributed to the inhibition to enforcement action. She, however, attributes the failure mainly to management's lack of accountability because of HUD/FHA's failure to disclose program financial results.

These explanations are both plausible and reemphasize the need for program monitoring. If HUD/FHA had more timely and accurate financial data and were to act sooner to enforce program compliance, it could avoid the Hobson's Choice that Larry Dale describes. The Department of Housing and Urban Development Reform Act of 1989 expanded the cease and desist authority of the Department and, thus, enhanced the ability of HUD/FHA to exercise lesser remedies than the draconian one of terminating a lender as a co-insurer.

Lenders failed to comply with program requirements relating both to loan origination and loan servicing. The enforcement failures of HUD/FHA and GNMA have aggravated the losses of GNMA and HUD/FHA, because co-insurers were allowed to continue to commit the Federal Government to the insurance of loans, notwithstanding the co-insurers' failure to engage in prudent, safe and sound loan underwriting and servicing and aggressive collection of defaulted loans. The Federal Government was exposed both to risk of loss on an increasing portfolio of poorly underwritten loans and to increasing losses on previously underwritten loans that were in default or likely to default.

V. Program Losses And Their Mitigation

A. GNMA's Losses Attributable To Co-Insurance

In its fiscal year that ended September 30, 1989, GNMA established a loss reserve of $50.5 million to cover "administrative and other costs" associated with its management of co-insurance portfolios that GNMA has taken over from co-insurers it has terminated.[106] This was the first full year that ended after GNMA's September 16, 1988, termination of DRG Funding Corp. as an issuer. Prior to completion of the 1989 audit, GNMA indicated that it anticipated future losses in its mortgage-backed securities program "and [would] reserve additional funds as these losses are probable and measurable."[107]

As noted earlier, to induce GNMA to assist in the securitization of co-insured loans FHA agreed to indemnify GNMA against losses attributable to the co-insurer's failure to satisfy its 20% share of the insurance liability on the loans.[108] The indemnification assured GNMA that, in the event it terminated a co-insurer as an issuer, it would have the right to convert the co-insured loan portfolio to a fully-insured loan portfolio. Full insurance benefits would be paid in accordance with normal rules, except that they would be paid in cash only.[109] Those rules contemplate that, if a mortgagee assigns an insured mortgage to HUD/FHA rather than foreclosing a defaulted mortgage, the insurance payment will be reduced by 1% of the insured debt.[110] In addition, there are certain administrative costs that GNMA bears in terminating an issuer that it cannot recoup from HUD/FHA.[111]

Notwithstanding this indemnification, when GNMA terminated DRG, it agreed to forbear from immediately exercising its rights under the indemnity arrangement. Instead, it agreed to accept insurance payments from HUD/FHA on the latter's 80% share of the liability just as if GNMA were a co-insurer. It did, however, insist on HUD/FHA's reimbursement of payments made by GNMA with respect to DRG's 20% share of the insurance liability. GNMA, in effect, forbore from insisting on its right to convert DRG's co-insurance portfolio immediately to fully insured status and to assign all defaulted loans to HUD/FHA for immediate insurance payment. In addition, GNMA agreed to absorb 50% of certain administrative costs that it would not have had to bear, if it had elected to assign the loans to HUD/FHA.[112]

HUD/FHA acknowledged in its Memorandum of Understanding with GNMA the existence of "staffing and procurement constraints" that prevented HUD/FHA from "readily perform[ing] [the] portfolio management functions itself or quickly arrang[ing] for the assistance of private contractors."[113]

As of September 1989 GNMA had defaulted additional co-insurers and was managing a co-insurance portfolio of 238 projects with an outstanding principal balance of approximately $1.3 billion of which approximately 43% were in default.[114]

As of March 23, 1990, the co-insurance portfolios under GNMA's control had grown to $1.8 billion of which approximately $0.8 billion was in default.[115]

While GNMA apparently has not entered into a memorandum of understanding with HUD/FHA regarding any portfolio other than the DRG portfolio, GNMA as of May 25, 1990, had converted to full insurance and obtained insurance payment on only one loan.[116] As of the same date it had converted an additional 52 loans to full insurance but not yet obtained payment and had submitted 14 more loans to HUD/FHA for full insurance endorsement.

GNMA's forbearance in converting the DRG portfolio to full insurance and delay in converting non-DRG portfolios to full insurance has delayed the impact of the co-insurer failures on HUD/FHA and caused a related cash drain on GNMA pending its obtaining insurance payments from HUD/FHA.[117] As the insurance losses are ultimately born by FHA's General Insurance Fund that is dependent upon appropriated funds to assure its solvency[118], the delayed impact upon HUD/FHA has affected the timing of the Federal Government's actual deficits.

GNMA's forbearance with respect to the DRG portfolio also has increased GNMA's losses to the extent of the administrative costs that it agreed to share with HUD/FHA 50/50 that it would not have had to bear in the absence of its forbearance. These costs are included in the $50.5 million loss reserve GNMA has established.

GNMA's forbearance or delay has relieved HUD/FHA at least temporarily of the burden of managing the defaulted loans in the defaulted issuers' portfolios. This has severely strained GNMA's management capacity. GNMA has had to rely upon private third party "subservicers" to respond to such strains. While GNMA recently has retained three private parties as "master subservicers" to whom GNMA can reassign outstanding portfolios under GNMA's control, GNMA has relied upon York Associates, Inc. to service the DRG portfolio that GNMA took over in September 1988. As noted above, the HUD IG found York to have engaged in loan underwriting that did not comply with co-insurance program requirements. York also is very highly leveraged, and has a substantial number of defaulted loans in its own co-insurance portfolio.[119] In selecting and continuing to rely upon York as the servicer of the largest and most troubled co-insurance portfolio that it has taken over GNMA has opted to rely upon an agent with its own substantial financial and management difficulties. These resulted in GNMA's termination of York as an approved GNMA issuer on July 13, 1990, and the substitution of a short-term contract with York regarding its servicing of the DRG portfolio. GNMA expects to transfer the servicing of both the York and DRG portfolios to one or more of its new master subservicers.[120]

RECOMMENDATION:

GNMA should provide to the Senate Banking Committee within 60 days of the HUD/Mod Rehab Investigation Subcommittee's Report a written explanation of the reasons for its original election to retain, and its continued reliance upon, York Associates, Inc. to service the co-insured portfolio that GNMA took over from DRG Funding Corp. GNMA's report should also explain when GNMA was first able to terminate York as an issuer and why termination of York did not occur earlier.

B. Ability of HUD/FHA to Mitigate Its Losses

HUD/FHA has underwritten a co-insurance portfolio of approximately $10 billion. HUD/FHA attributes most of its losses-realized and expected-to "overmortgaging" or lending in excess of project value.[121] HUD's auditors concur that HUD/FHA's absolutely dismal 40 percent recovery rate on defaulted co-insured loans provides confirmation of overmortgaging, and HUD/FHA is "suffering a lot of losses now because of the poor underwriting in many cases."[122] Obviously, HUD/FHA can do nothing now to undo the prior underwriting.

However, there are actions that both HUD/FHA and GNMA can and should take now to mitigate the losses that may result from the prior, deficient underwriting.

(1) Minimizing Interest Costs

The most significant, potential cost that GNMA and HUD/FHA can reduce is the interest cost on the GNMA-guaranteed securities that are backed by defaulted co-insured loans. Insurance claims, including those for interest not paid on defaulted co-insured loans, are paid from the HUD/FHA's General Insurance Fund. This Fund borrows from the Treasury Department to fund its cash shortfalls.[123] Appropriations are also used to fund cash shortfalls and to retire the borrowings from the Treasury.[124] If the interest rate on GNMA-guaranteed securities backed by a defaulted loan exceeds either the interest rate on the Fund's borrowings from the Treasury or the Treasury's rate on its borrowings to fund appropriations (the "Treasury rate"), the Federal Government bears the cost of the rate differential. The interest rat[illegible] GNMA-guaranteed securities, when issued, are somewhat higher th[illegible] Treasury borrowing rate for a comparable term. As market rates change, it is possible for the rate on a previously issued security to be less than the current Treasury rate.

HUD/FHA has not disclosed whether it has realized the cost of paying interest on GNMA-guaranteed securities backed by defaulted co-insured loans at rates that exceeded the Treasury rate. No such cost is reflected in the $960 million loss reserve that HUD/FHA has established for the co-insurance programs.[125] This cost is incurred, as the co-insurer (or GNMA, if GNMA has taken over loan servicing from a co-insurer) continues to pay interest to the investor in the GNMA-guaranteed securities, while the co-insurer (or GNMA) proceeds with foreclosure of the defaulted loan, sale of the project following foreclosure, and application to HUD/FHA for payment of its 80% share of the insurance liability. If foreclosure is delayed, the interest paid to investors and included in the insurance claim against HUD/FHA can be very substantial.[126]

Participants in the Subcommittee's March 27, 1990, roundtable discussion emphasized that avoiding payment of interest at a rate that-exceeded the Treasury's borrowing rate should be a priority at GNMA and HUD/FHA.[127] How is this accomplished? It requires either modification of current co-insurance program regulations to provide for acceleration of payment by HUD/FHA of insurance benefits on defaulted loans or administrative determination by HUD/FHA to convert co-insured loans to fully-insured loans that can be immediately assigned to HUD/FHA for insurance payment following the borrower's default. Either action would facilitate earlier retirement of the GNMA-guaranteed security by the earlier payment of HUD/FHA insurance benefits that are "passed through" to the investor. This would collapse the period during which interest continues to be paid to the investor at a rate higher than the Treasury rate.

Under current program regulations HUD/FHA defers payment of insurance benefits on co-insured loans until the co-insurer's completion of foreclosure of a defaulted loan and either sale of the loan's collateral or the appraisal of the collateral by two appraisers and the elapse of twelve months from foreclosure.[128] If GNMA has taken over loan servicing from a co-insurer, GNMA has the right to convert a co-insured loan, whether or not in default, to a fully-insured loan. If the loan is in default, GNMA may assign the loan to HUD/FHA and obtain payment of insurance benefits.

GNMA's procedures require the co-insurer to pass through the insurance benefits from HUD/FHA to the investor and the co-insurer's simultaneous or earlier payment to the investor of any amount needed to retire the GNMA-guaranteed security that is not satisfied by the insurance benefits.[129]

With respect to co-insurance portfolios that GNMA has not taken over the co-insurers cannot accelerate the receipt of insurance benefits from HUD/FHA in the absence of either acceleration in the foreclosure of defaulted loans and sale of the collateral or change in the programs' current strictures. HUD has indicated that it is developing new procedures "for advance payment of claims" that "will provide liquidity to lenders with defaulted loans."[130] In addition to relieving co-insurers' liquidity problems the acceleration of payment of insurance benefits could be used to reduce ultimate program interest costs. HUD's proposal responds to recommendations made earlier by co-insurance program participants.[131]

Because the HUD/FHA proposal to make advance payments on its co-insurance liability does not change the status of the loans as co-insured loans[132], the proposal does not have the same effect as the HUD/FHA indemnity provision that applies, when a co-insurer defaults on its contract with GNMA and GNMA can demand that HUD/FHA convert the lender's whole co-insurance portfolio to fully-insured status. However, there are means available to HUD/FHA to convert co-insurance portfolios of lenders not yet in default to GNMA to fully-insured portfolios. Participants in the co-insurance programs have broached with HUD/FHA such a wholesale conversion. A significant consequence of the conversion would be that, in the event of a loan default, the lender would be able to assign the defaulted loan to HUD/FHA for immediate payment of full insurance benefits. There are a host of considerations that HUD/FHA would have to take account of before agreeing to such a conversion. These include the housing preservation duties of HUD/FHA under Section 203 of the Housing and Community Development Act of 1978, as amended, that apply to defaulted multifamily loans assigned to HUD/FHA or multifamily projects conveyed to HUD/FHA.[133] This report does not attempt to analyze those considerations. The purpose here is to point out that the conversion would facilitate more rapid retirement of the GNMA-guaranteed securities that are backed by defaulted co-insured loans.

As noted earlier, GNMA agreed with HUD/FHA with respect to the DRG Funding Corp. portfolio that it would forbear from exercising its right to convert the portfolio from co-insured to fully-insured status. As a result, GNMA has settled for obtaining insurance benefits from HUD/FHA in accordance with the co-insurance program strictures described immediately above that delay payment of the benefits for up to three years, if foreclosure requires up to two years (as it frequently does) and the collateral is not sold at or within 12 months of foreclosure. So long as the project collateral remains unsold or the insurance benefits remain unpaid, interest continues to accrue and be paid on the GNMA-guaranteed securities backed by the DRG co-insurance portfolio.

Even as to co-insurance portfolios other than DRG's that GNMA has taken over GNMA apparently has been slow in exercising its right to convert co-insured loans to fully-insured status. As noted earlier, as of May 25, 1990, GNMA had obtained full insurance benefits from HUD/FHA on only one loan. With this one exception HUD/FHA prior to April 1990 had only paid insurance benefits to GNMA under the program strictures that apply to co-insurers' receipt of benefits![134] By delaying its receipt of insurance benefits from HUD/FHA GNMA has aggravated the ultimate loss to the Federal Government, if the rates on the securities backed by the defaulted loans have exceeded the Treasury rate.

RECOMMENDATION:

The Department of Housing and Urban Development should make every effort to minimize the losses, including the interest cost, that the Federal Government ultimately will absorb with respect to co-insured loans that default, so long as these efforts are economically advantageous.

To such end, so long as HUD/FHA continues to have liability as a co-insurer rather than a full insurer, HUD/FHA should modify the co-insurance program regulations to permit the acceleration of payment of co-insurance benefits. HUD/FHA, taking account of historical data regarding the relationship of interest rates on Ginnie Mae and Treasury securities, should accelerate payment, when such action would avoid the payment of interest on GNMA-guaranteed securities that are backed by co-insured loans in default at rates that exceeded the Treasury's borrowing rate. To a similar end, GNMA should exercise immediately its right of indemnification by HUD/FHA with respect to co-insurance portfolios taken over by GNMA, and HUD/FHA should cooperate fully with GNMA in expediting the conversion of defaulted co-insured loans to fully-insured status and the subsequent payment of full insurance benefits on such loans.

RECOMMENDATION:

The Department of Housing and Urban Development should report to the Congress within 60 days of the Subcommittee's Report the conditions under which the Department would approve the conversion to fully-insured status of co-insurance portfolios not yet controlled by GNMA.

The acceleration of payment of insurance benefits by HUD/FHA, whether by change in the co-insurance program regulations or the conversion of co-insured loans to fully-insured status, will cause cash drains on HUD/FHA that previously have been born by GNMA. It will be in HUD/FHA's interest to minimize this drain by developing procedures for accelerating the liquidation of the collateral for the defaulted co- or fully-insured loans. If the loans are converted to fully-insured status, the Multifamily Mortgage Foreclosure Act becomes applicable.[135] Its procedures for non-judicial foreclosure expedite project acquisition. The risk of the project borrower declaring bankruptcy to delay its loss of control of the project continues to exist. At the Subcommittee's March 27, 1990, roundtable discussion certain participants indicated that technical amendments to the Bankruptcy Code would be desirable to facilitate insured lenders' or HUD/FHA's acquisition of control over project receipts and to deter borrower bankruptcies, where the borrower has no reasonable prospect of reorganization.[136]

RECOMMENDATION:

The Department of Housing and Urban Development should review whether Bankruptcy Code amendments such as those recommended by the Mortgage Bankers Association are necessary to protect insured lenders' security interests in project cash receipts and to prevent delays in project foreclosures due to bankruptcy filings of borrowers that have no reasonable prospect of reorganization in bankruptcy. The Department should make legislative recommendations expeditiously following such review.

If defaulted co-insured loans are not converted to fully-insured status, HUD/FHA needs to consider whether the Multifamily Mortgage Foreclosure Act should be amended to benefit co-insuring lenders as well as HUD/FHA. Even in the absence of such amendment HUD/FHA could take actions that are likely to expedite the foreclosure process. These include the increased participation by HUD/FHA in foreclosures. While the co-insurance programs were designed to relieve HUD/FHA of the burden of dealing with loan defaults[137], HUD/FHA must act prudently to minimize its losses, when loans default. If, as participants in the co-insurance programs represent[138], the more aggressive participation by HUD/FHA in foreclosure proceedings as amicus curiae (or co-plaintiff) would persuade borrowers or courts to allow more expeditious foreclosures, then HUD/FHA should take such action. It is shortsighted to delegate to the co-insurer the accomplishment of the foreclosure process, if the ultimate cost of delay in that process is born by HUD/FHA.

RECOMMENDATION:

The Department of Housing and Urban Development should determine whether to recommend to the Congress that the Multifamily Mortgage Foreclosure Act be amended to apply to co-insuring lenders as well as to HUD/FHA. In addition, HUD/FHA should participate aggressively in the loan foreclosure process with the object of accelerating the completion of that process.

(2) Facilitating Loan Work-Outs

As previously noted, a significant consequence of the co-insurance programs' design has been an unanticipated illiquidity, when loans default, due to the co-insurers' continuing obligation to pay investors in the GNMA-guaranteed securities that are backed by the co-insured loans in default. Also, HUD/FHA has announced that it expects to modify its insurance claims procedure for co-insured loans to provide for advance payment of insurance benefits in order to relieve this liquidity problem.

An improvement in co-insurers' liquidity should enhance their ability to continue in business and negotiate loan work-outs, where appropriate. Previously, co-insurers' desperate need for cash, when loans defaulted, motivated them to proceed to foreclosure as soon as possible rather than attempt a loan work-out, as any delay in obtaining title to the defaulted project deferred the co-insurers' right to obtain insurance benefits from HUD/FHA. HUD/FHA has acknowledged that, while its data is poor, loan work-outs have occurred infrequently.[139]

Loan work-outs, where feasible, may reduce the losses realized by HUD/FHA or GNMA. HUD/FHA has a number of available options to facilitate loan work-outs with respect to fully-insured loans that default. These options include loan modification and insurance of operating loss loans and supplemental loans for project improvements or additions. Modification of fully-insured multifamily loans is possible under Section 239 of the NHA[140] or through insurance of a refinanced loan under the authority of Section 223(a)(7) of the NHA[141]. Section 223(d) of the NHA authorizes HUD/FHA's insurance of operating loss loans to cover shortfalls in project net operating income for periods up to two years.[142] Section 241 of the NHA authorizes HUD/FHA to insure supplemental loans to finance project improvements or additions.[143]

Section 244 of the NHA, the general co-insurance authority, permits HUD/FHA to co-insure any loan insurable under Title II of the NHA, including any loan insurable under Section 223(a)(7), 223(d), or 241. However, as previously noted, HUD/FHA in designing the co-insurance programs did not anticipate the need for the availability of the additional extensions of credit to facilitate loan work-outs that are possible under these authorities and Section 239 of the NHA. This failure is related to HUD/FHA's desire and expectation that the co-insurer would relieve HUD of the burden of loan collection and enforcement. It did not reflect an assessment that Section 223(f) or 221(d) loans were safe credits. The work-out authorities continue to be available in the event of current or future loan defaults. While HUD/FHA may elect not to co-insure refinanced loans, operating loss loans, or supplemental loans, it could elect to insure fully any such loan or consent to the modification of a co-insured loan in order to facilitate cure or work-out of a default on a co-insured loan.

As Professor Robert Edelstein has noted, "carefully controlled loan work-out flexibility can reduce ultimate loan loss ratios."[144] HUD/FHA and GNMA have neglected to develop co-insurance program changes that would enhance the prospect of mitigation of program losses through the selective use of available loan work-out remedies.[145] HUD has acknowledged that "GNMA knows of no actions which it could have taken [to mitigate program losses] that it did not," and HUD/FHA has received proposals from co-insurers that "HUD provide 'operating loss loans' and 'partial payment of claims', but to date no viable program options have emerged!"[146] This acknowledgement reflects a lack of appreciation of the necessity to mitigate program losses by all possible means, including loan work-outs where appropriate.

RECOMMENDATION:

The Department of Housing and Urban Development should give high priority to the mitigation of losses that may be realized from the co-insurance programs. The Department should take all possible action to reduce such losses, so long as they are economically advantageous, including consenting to the modification of co-insured loans or providing insurance of refinanced loans, operating loss loans, or supplemental loans, where the additional extension of credit is appropriate to facilitate the cure or work-out of a co-insured loan in default.

(3) Improvement in Program Monitoring

This report has discussed previously HUD/FHA's failure to anticipate the need for, or to establish, an adequate system of monitoring the performance of co-insurers and their compliance with program requirements. The co-insurance portfolios total approximately $10 billion. GNMA controls the servicing of approximately $3.9 billion of this total. Private lenders continue to service approximately $6 billion, yet HUD/FHA has elected not to implement the recommendations of Price Waterhouse regarding necessary improvements in program monitoring.[147] "HUD concurs with the Price Waterhouse findings. However, in light of HUD's intention to terminate the co-insurance program, HUD does not plan to significantly expand its capacity to monitor co-insuring lenders."[148] HUD's decision ignores the relationship between program monitoring and program losses. The Price Waterhouse recommendations are relevant to the more than 60% of the co-insurance portfolios that are managed by private lenders. The recommendations would facilitate the mitigation of losses on these portfolios by enabling HUD/FHA to obtain timely information on the financial condition of these lenders, the status of each of the co-insured loans, and the actions that they are taking or failing to take to improve their condition, to avoid loan defaults, and to collect aggressively or work-out those loans in default. If HUD/FHA were to consider seriously lenders' proposals to convert their co-insurance portfolios to fully-insured loans, the data obtained from the improved monitoring would enable HUD/FHA to negotiate more commercially appropriate terms of any such conversion, as HUD/FHA would better appreciate the insurance risk it would be assuming by such a conversion.

Price Waterhouse noted that "enhanced reporting and monitoring of lender activities" can help "increase the effectiveness of the co-insurance program by reducing economic losses."[149] While HUD has announced its intention to terminate the co-insurance programs, it also has indicated it will allow the continued origination of co-insured loans until the programs are terminated.[150] So, improved monitoring would mitigate loss on a gradually increasing portfolio of co-insured loans.

Price Waterhouse recommends improvements in HUD/FHA's systems of gathering and analyzing data regarding individual lenders and individual projects within a lender's loan portfolio. It compares HUD/FHA's current systems with those of FNMA and observes that "[t]he manner in which Fannie Mae analyzes project information as well as the type of information it gathers can provide useful guidance to HUD."[151] Price Waterhouse further notes that HUD/FHA has assumed risk by its choice of co-insurers and the co-insurers' choice of projects. Price Waterhouse states that "[i]t is important to identify, early on, co-insuring lenders who are becoming financially weak so that HUD can take the appropriate steps to alleviate its losses."[152]

Price Waterhouse also compares HUD/FHA's monitoring system with those of the Federal bank regulators and concludes that HUD/FHA could usefully follow the latter's models. It notes, for example, that the manner in which bank regulators conduct field examinations of lenders allows "for an in-depth assessment of the lender's asset quality and thus of the adequacy of its loss reserves."[153] Price Waterhouse recommends that HUD/FHA focus immediately on the review of co-insurers' loan asset quality.[154] It notes that "without further development of credit examination capabilities, HUD cannot consider itself informed of the extent of its exposure on an ongoing basis."[155] It also notes that GNMA using Coopers & Lybrand has developed a capacity to review the financial status of participants in GNMA's mortgage-backed securities programs. "[A]t a minimum, FHA should become familiar with and build upon" GNMA's monitoring system.[156]

RECOMMENDATION:

The Department of Housing and Urban Development should take immediate action to improve its systems of monitoring the insurance risk that HUD/FHA has assumed and continues to assume under the co-insurance programs. These improvements should include those recommended by Price Waterhouse in its January 18, 1990 Report to the Department on the co-insurance programs.

The improvements should provide immediate training of appropriate HUD/FHA staff in credit risk monitoring and evaluation. The improvements, also, should establish improved coordination between GNMA and HUD/FHA in the conduct of examinations of private lenders.

(4) Improvement in Reporting of Financial Condition

The Price Waterhouse audit of the FHA insurance funds as of September 30, 1988, was performed to enable GAO to satisfy its responsibility under the Government Corporation Control Act to audit FHA every three years.[157] HUD/FHA has retained Price Waterhouse to perform an audit of the FHA insurance funds as of September 30, 1989, to satisfy HUD/FHA's new obligation under HR 1 to make available to the public annual audited financial statements of the FHA insurance funds.

Financial statements reflect judgments on a host of accounting issues. As the 1989 financial statements will be the first under HUD/FHA's new reporting obligations, and GAO was responsible for the most recent financial statements on the FHA insurance funds, GAO's review and comment on the 1989 financial statements would assure that the Congress was made aware of any material accounting issues that HUD/FHA might elect to address differently from the manner in which GAO addressed them in the 1988 financial statements.

RECOMMENDATION:

The General Accounting Office should review the audited financial statements prepared by the Department of Housing and Urban Development for the FHA insurance funds as of September 30, 1989, and report to the Senate Banking Committee any material comments that it has on such statements, particularly any comments comparing accounting judgments in such statements with those in the September 30, 1988, financial statements prepared by GAO.

VI. The Continued Validity of the Co-Insurance Concept

HUD/FHA's failure to implement successfully co-insurance programs does not invalidate the concept of co-insurance. The program experience merely illustrates that a sound concept can be poorly executed.

Co-insurance involves risk sharing. The concept of risk sharing is "an important concept not just in multifamily lending but in all real estate lending" that is "increasingly used and increasingly viable."[158] HUD/FHA's determination to replace co-insurance with a full insurance program reflects an abandonment of risk sharing at a time, when other participants in real estate lending are embracing the concept. As Professor Edelstein observed, HUD's decision to give up on co-insurance is like "'throwing the baby out with the dirty bath water.'"[159]

Co-insurance enables the party sharing risk to minimize risk associated with "moral hazard" and "adverse selection." Professor Edelstein explained these terms as follows:

> In a 100% loan insurance program FHA-HUD bears additional risks relating to behavior disincentives. First, there is moral hazard, i.e., developers, real estate investors, and lenders may undertake or conduct business in ways they would not if they were at risk. They do this because their returns can be changed but the risk bearing they absorb does not change commensurately. These situations are obviously dangerous to the insurer. Second, there is adverse selection of projects offered to the 100% loan insurer. To the extent that lenders can differentiate subtle risks of projects in a way that the insurer can not, the lender will insure those projects that are riskier. To the extent that people 'playing on the field' can tell more about the ball game than those 'observing from the stands,' the analogy suggests that FHA-HUD as a 100% loan insurer is likely to confront adverse selection in its loan insurance portfolio.[160]

With co-insurance the lender assumes some of the underwriting risk, so it at least conceptually must be more careful in its project selection. Its greater care benefits it and its co-insurer by reducing the moral hazard and adverse selection risks to the co-insurer.

Co-insurance also takes advantage of the loan originator's knowledge of the local marketplace. "Since real estate is a 'local' business, the loan originating lender in the local marketplace is uniquely situated to determine the overall risks of the loan."[161] FNMA recognizes this advantage of local, 'primary' lenders. Larry Dale indicated that "[w]hile we can fully underwrite a project loan as effectively as a primary lender, it takes us significant time and effort to do so."[162]

FNMA's Delegated Underwriting and Servicing Program ("DUS Program") illustrates how risk sharing in multifamily lending can work successfully. FNMA has committed to purchase approximately $2 billion of loans from 26 approved lenders that include at least 12 participants in HUD/FHA's co-insurance programs. As of March 27, 1990, the default rate on loans originated under this program was "less than one percent."[163] More recently, FNMA has indicated that only one of 600 loans originated under the DUS Program was in default.[164]

Under the DUS Program there are three levels of risk sharing. "In a normal transaction [Level I], the lender is liable for the first five percent of the loan, 25% of the next 20%, and 10% of any remaining loss."[165] In certain circumstances the lender can opt for a higher level [Level II] of risk sharing with a maximum loss exposure of 30% of the original loan amount. FNMA also, as a remedy for the lender's default under the program requirements, can require the lender to absorb an increase in loss sharing from either Level I to Level II or Level II to Level III which has a maximum loss exposure of 40% of the original loan amount.[166]

FNMA requires the lender to collateralize its risk sharing obligation to FNMA with a lender reserve in the form of an AAA-rated letter of credit in an amount that is determined on the basis of the aggregate loans a lender has originated under the DUS Program. If as a sanction FNMA requires greater risk sharing, the lender must increase its lender reserve.[167]

FNMA also requires lenders to operate on probation until they have originated $50 million of loans under the program. During the probationary period the lenders' underwriting is subject to closer monitoring review by FNMA. FNMA can extend the probationary period, if necessary.[168]

FNMA has established a program fee structure that is skewed to the "back end" by requiring lenders to collect a loan servicing fee during the life of a loan of between 25 and 50 basis points.[169]

FNMA further has provided for a spectrum of remedies to enforce its program requirements. "When we find a lender that violates our guidelines, we penalize them with a higher degree of risk-sharing which mitigates our risk and gets their attention very quickly."[170]

The dramatically lower loan default rate under the DUS Program confirms that co-insurance or risk sharing among lenders or insurers is a valid concept that can be successfully implemented. The one default in the DUS Program as of June 20, 1990, is particularly noteworthy in light of the significant number of co-insurers that have participated in the program.

RECOMMENDATION:

The Department of Housing and Urban Development should give careful, further consideration of how it could successfully implement the co-insurance authority of Section 244 of the National Housing Act with respect to multifamily project loans. If the Department determines that the conditions to successful exercise of this authority require further statutory definition beyond the amendments effected by the Department of Housing and Urban Development Reform Act of 1989, it should submit its legislative recommendations to the Senate Banking Committee within 60 days of the Subcommittee's Report.

VII. Elements Necessary To A Successful Insurance Program That Provides For Delegated Processing of Multifamily Project Loans

HUD is engaged in designing a delegated processing, full insurance program that is supposed to replace the co-insurance programs. HUD now has the opportunity to demonstrate its ability to learn from its past mistakes. In designing the substitute program HUD must not ignore certain administrative realities that affect its ability to carry out the multifamily mortgage insurance function. In addition, HUD needs to include certain features in the program design that are known means to avoidance or mitigation of future loss from mortgage insurance underwriting.

A. Underwriting Capacity

HUD/FHA initiated the co-insurance programs in response to the decline in its staff capacity to underwrite multifamily loans.[171] Approvals of full insurance applications were requiring up to two years to obtain. In embarking upon co-insurance HUD/FHA determined to rely upon the underwriting staff of private lenders.

HUD/FHA's underwriting capacity has continued to decline since the commencement of the current co-insurance programs. Both HUD and parties that deal with it agree upon the acute deficiency in the agency's insurance underwriting capabilities. George Hipps, formerly a senior career official within

HUD and now an officer with a co-insurer, has observed that "there is virtually no capacity within HUD to perform such [mortgage insurance] functions in-house in a timely manner and provide quality work in any environment involving significant volume."[172]

HUD FHA Commissioner C. Austin Fitts has indicated that HUD/FHA has one actuary for an FHA insurance portfolio of $300 billion![173] She has further described HUD/FHA's current condition as follows:

> But what I will tell you again and again...[is that the staff] are asked to do highly specialized financial functions, when they are generalists....
> What I have found consequently, both in the area of co-insurance and in the area of title X, is that they do not have the underwriting skills in many instances, given their workload, to make good assessments.[174]

More recently HUD has acknowledged a need to improve substantially its underwriting capacity in order to undertake the full insurance program involving delegated processing that HUD has announced it intends to establish in substitution for co-insurance. HUD has observed as follows:

> Since the early 1980s, [Office of] Housing's technical underwriting staff in both headquarters and the field has decreased substantially....
>
> Many of the remaining technicians are senior staff with long tenure, and it expected that attrition through retirement will be heavy.
>
> If the Department were to resume past levels of full insurance activity, it would have to initiate a recruiting and training program to rebuild underwriting capacity....[175]

The Mortgage Bankers Association has made a similar assessment of HUD's current capacity.[176]

The Administration and the Congress face a choice in these circumstances of either undertaking to reestablish HUD/FHA's multifamily mortgage underwriting capacity--an undertaking that will require substantial time and investment--or to consider alternative means for the delivery of such credit underwriting.

Realistically, the Administration faced this choice, when it assumed office in January 1989. The Administration is now almost halfway through its term, and yet it has not resolved how it can successfully manage a multifamily mortgage insurance function within the Federal Government. The delay in resolution of this threshold issue in the meanwhile is severely compromising the ability of the Federal Government to address the apparent need for low and moderate income housing in the United States.

The housing bill recently passed by the Congress directs the HUD Secretary to implement a full insurance, delegated processing program within 60 days of enactment of the pending legislation.[177] It, also, contemplates that HUD will develop and maintain the in-house staff capacity to operate a "viable" multifamily mortgage full insurance program.[178] Thus, Congress has determined to restore HUD/FHA's multifamily mortgage insurance underwriting capacity.

HUD has indicated that prior to implementing the proposed delegated processing program it will issue an advance notice of proposed rule making that will outline major program features.[179] Also, prior to implementation the Department will need to determine the time frame within which--and the manner in which--it can prudently and feasibly increase loan underwriting volume and the resources required to implement the program.

RECOMMENDATION:

Prior to undertaking to underwrite multifamily project loans on a full insurance basis in lieu of co-insurance, the Department of Housing and Urban Development should adequately address the design and implementation flaws in the co-insurance program and identify and obtain the human and other resources necessary to carry out such underwriting in a prudent, safe and sound manner.

On or before the Department's issuance of its advance notice of proposed rulemaking regarding the proposed underwriting program, it should disclose the financial and human resources it will require to implement the program.

The HUD/FHA has problems of long standing in its internal accounting and financial management that prevented it from issuing between 1974 and 1988 audited financial statements regarding the FHA insurance funds. These continuing problems have been the subject of numerous reports by GAO and the HUD Inspector General as well as of HUD's own reports under the Federal Managers Financial Integrity Act. The "material weaknesses" in internal control procedures and financial management systems, that HUD/FHA has acknowledged continue to exist, materially impair the capacity of HUD/FHA to perform mortgage insurance underwriting.

RECOMMENDATION:

Prior to undertaking to underwrite multifamily project loans on a full insurance basis in lieu of co-insurance, the Department of Housing and Urban Development should adequately remove the material weaknesses in HUD/FHA's internal controls and financial management systems that materially impair the capacity of HUD/FHA to perform multifamily mortgage insurance underwriting.

B. Focus on Certain, More Familiar Real Estate Lending Markets

As noted in the previous discussion of the continued validity of the co-insurance concept, real estate lending is a business that depends greatly upon knowledge of local markets. Local lenders know the market better than HUD/FHA or FNMA. Particularly in light of the severely limited underwriting capacity of HUD/FHA at this time, HUD/FHA should embark on an expanded, multifamily project full insurance program only within real estate lending markets that are geographically and by loan program well known to HUD/FHA staff. Only as the agency demonstrates its ability to undertake the expanded program should the agency engage in underwriting activity in less familiar markets.

RECOMMENDATION:

In designing a full insurance program that substitutes for the co-insurance programs the Department of Housing and Urban Development should focus on insurance underwriting in selected real estate lending markets that are geographically and by loan program well known to HUD/FHA. Only as the Agency's underwriting capacity expands should it engage in underwriting in less well known lending markets.

C. Program Franchise Value

In designing an expanded full insurance program HUD/FHA should attempt to design a program that like FNMA's DUS Program has a "franchise value" to the program's participants. "Franchise value" means that the participants value their credit relationship with HUD/FHA and GNMA sufficiently to be motivated to continue the relationship over the long term. Continuation is dependent upon compliance with program requirements. Larry Dale has noted that it is difficult for government agencies to design their programs with such a "franchise value", as "[t]he Government sets up minimum standards and anybody that meets the minimum standards can become a participant."[180] HUD/FHA designed the co-insurance programs on such "lowest common denominator" terms. Most program participants were lenders that had participated in HUD/FHA's full insurance programs.[181] HUD/FHA did not adequately consider the distinctions between full insurance and co-insurance that would warrant different requirements.

HUD/FHA has a new opportunity to attempt to establish criteria for participation in its proposed full insurance, delegated processing program that will be sufficiently rigorous that program participants will value-as well they should!-the Federal Government's credit enhancement of their mortgage lending.

RECOMMENDATION:

In designing the proposed full insurance, delegated processing program the Department of Housing and Urban Development should make every effort to establish program requirements that are sufficiently rigorous to minimize the Federal Government's insurance risk.

D. Risk Sharing

While HUD has indicated that it does not mean to use the co-insurance authority of Section 244 of the NHA, when it embarks upon its proposed program to replace the co-insurance programs, such intention need not preclude risk sharing between HUD/FHA and the fully insured lender. HUD/FHA has broad discretion to prescribe the terms and conditions on which it makes available full insurance of multifamily mortgages.[182] These terms and conditions could include rigorous representations and warranties by the insured lender regarding the nature and extent of its compliance with stated underwriting requirements, capital requirements that better assure lenders' financial capacity to honor any liability to HUD/FHA on such representations and warranties, collateralization of obligations to maintain project reserves for repair or operating expenses that better assures the availability of funds needed for continued project feasibility, or variation in insurance premiums that depends upon HUD/FHA's assessment of its risk. As noted in the discussion of the continued validity of the co-insurance concept, risk sharing is the prevailing practice in real estate lending today.

RECOMMENDATION:

If the Department of Housing and Urban Development continues to propose to substitute full insurance programs for the co-insurance programs, it should provide for risk sharing between HUD/FHA and the insured lender within the discretion permitted by the NHA without exercise of the co-insurance authority of Section 244 of the NHA (which HUD/FHA would not mean to exercise with a full insurance program.)

E. Need for Program Monitoring

HUD has indicated that it does not believe the recommendations by Price Waterhouse regarding necessary improvements in co-insurance program monitoring are relevant to HUD/FHA's full insurance programs.[183] HUD explained that "[u]nder full insurance, lenders do not have significant capital at risk. HUD, therefore, does not need to implement for its full insurance program the higher capital and financial reporting requirements which Price Waterhouse recommended for co-insurance."[184] While the specific capital requirements that Price Waterhouse recommended for the co-insurance program may not be the precise ones appropriate for the proposed full insurance program, the capital requirements should take account of the need for assurance that HUD/FHA will have satisfactory recourse against lenders for breach of warranty or misrepresentation, as noted above. Many of the Price Waterhouse recommendations that relate to HUD/FHA's improvement of its capacity to monitor and analyze the credit risk reflected in an insured loan portfolio are as relevant to a full insurance as to a co-insurance program. As an insurer, HUD/FHA must know on a continuing basis the credit risk that it has assumed by underwriting multifamily loans. Otherwise, for example, how is HUD/FHA able to establish appropriate loss reserves and report accurately its financial condition annually as now required? Also, careful monitoring of its credit risk is necessary to enable HUD/FHA to determine whether lenders are originating loans that conform with program requirements and the recommended representations and warranties to HUD/FHA. Careful monitoring also is necessary to rapid response to defaults on insured loans. Aggressive loan collection and enforcement prevents later losses.[185] Since HUD/FHA absorbs all the loss on fully-insured loans, it has at least as great a financial interest to protect through an adequate monitoring program under full insurance as under co-insurance.

RECOMMENDATION:

In designing the proposed full insurance, delegated processing program the Department of Housing and Urban Development should anticipate the need for, organize, and obtain the resources necessary to implement program monitoring that will enable HUD/FHA on a continuing basis to know its risk of loss and to respond quickly to loan defaults.

F. Actuarial and Program Objectives

In designing the co-insurance programs HUD/FHA undertook actuarial studies to determine the manner of allocation of insurance premiums between HUD/FHA and the co-insurer in order to satisfy the statutory requirement that the co-insurer share the insurance premiums with HUD "on a sound actuarial basis."[186] HUD/FHA did not go further. It did not, for example, anticipate a loss experience different from that under the full insurance programs and, therefore, did not alter the total insurance premiums collected from borrowers.[187] Also, in designing the co-insurance programs HUD/FHA did not define and implement clear program objectives by which the co-insurance programs could be evaluated.

In order to facilitate substantial improvement by HUD/FHA in the quality of its multifamily insurance underwriting and Congressional oversight of the full insurance program that HUD/FHA proposes to substitute for co-insurance HUD/FHA should develop criteria by which it and the Congress may evaluate the success of the program. The criteria should include both financial and non-financial measures. They should enable both HUD/FHA and the Congress to determine on a continuing basis whether and to what extent HUD/FHA is achieving stated housing goals and insurance underwriting objectives.

RECOMMENDATION:

In designing the full insurance, delegated processing program the Department of Housing and Urban Development should define clear program objectives relating to both housing goals and insurance underwriting objectives and specific criteria by which HUD/FHA and the Congress can measure the success of HUD/FHA in achieving the objectives.

HUD/FHA funds losses on the multifamily co-insurance programs from HUD/FHA's General Insurance Fund. HUD/FHA does not have to manage this fund on a sound actuarial basis.[188] Congressionally appropriated funds cover losses that exceed the other assets of this Fund.[189] The statutory provisions relating to the General Insurance Fund do not define any alternative basis on which the Fund is to be managed. This absence of actuarial standard may encourage HUD/FHA to believe that the Congress is willing to permit substantial losses on programs funded from the General Insurance Fund. Congress, of course, has not sanctioned the losses that HUD/FHA has realized or that are likely to be realized under the co-insurance programs. Congress should expect HUD/FHA to carry out its multifamily mortgage underwriting activities with a sense of fiduciary concern and accountability. In order to avoid any repetition of HUD/FHA's dismal record in the co-insurance programs the Congress should clarify the standard by which it expects to measure HUD/FHA's management of the General Insurance Fund.

RECOMMENDATION:

The Congress should amend the statutory provisions relating to the FHA's general insurance fund to clarify the actuarial standard or standards that are to govern HUD/FHA's management of such fund and the mortgage insurance programs that are funded from it.

ENDNOTES

1. U.S. Department of Housing and Urban Development, Report on Compliance with the Federal Managers' Financial Integrity Act, December 29, 1989, at 1.

2. Section 244 of National Housing Act prior to its amendment by the Department of Housing and Urban Development Reform Act of 1989, 12 U.S.C. Section 1715z-9.

3. U.S. Department of Housing and Urban Development, Office of Housing-Federal Housing Commissioner, Multifamily Mortgage Co-insurance Programs, undated ("HUD Summary of Co-insurance Programs").

4. Id. at 6, 9.

5. Id. at 6; U.S. Department of Housing and Urban Development, Government National Mortgage Association, Mortgage-Backed Securities Guide, Handbook GNMA 5500.1 REV-6 (September 1989) ("GNMA Mortgage-backed Securities Guide") at 16-6.

6. 24 C.F.R. Sections 251.824-251.828; 24 C.F.R. Sections 252.824-252.828; and 24 C.F.R. 255.824-255.828(1990).

7. U.S. Department of Housing and Urban Development, Notice of Proposed Rule Making Regarding Termination of the Multifamily Co-insurance Program, 55 F.R. 11332 (March 27, 1990)("HUD Co-insurance Program Termination Rule").

8. U.S. Department of Housing and Urban Development, Office of Policy Development and Research, "Multifamily Co-insurance," (a 4 page undated options paper) ("PD&R Options Paper") at 2. This document is included in the certified administrative record in Housing Study Group v. Kemp, Civil Action No. 90-0244(D.D.C.).

9. Id.

10. HUD Co-insurance Program Termination Rule, 55 F.R. at 11332-11333; Price Waterhouse, Review of Capital and Administrative Requirements, Multifamily Co-insurance Programs (January 18, 1990) ("Price Waterhouse Consulting Report on Co-insurance") at II-18.

11. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to questions of HUD/Mod Rehab Investigation Subcommittee. (See response to question 7 regarding program losses), Hearings, Vol. 1, March 27, 1990, at p. 413.

12. Hearings (full Committee), September 27, 1989, Bowsher at 38.

13. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to questions from Subcommittee. (See response to question 7 regarding program losses.), Hearings, Vol. 1, March 27, 1990, at pp. 411-15.

14. Price Waterhouse, Independent Auditors' Report to the Comptroller General of the United States and the Secretary of Housing and Urban Development, dated September 15, 1989, ("Price Waterhouse Audit of FHA") at note 8, p.41 of General Accounting

Office, Report to the Congress regarding Financial Audit, Federal Housing Administration's Fund's 1988 Financial Statements, dated February 9, 1990 ("GAO Report on FHA Fund").

15. Larry Dale, Senior Vice President, Multifamily Finance and Housing Initiatives, FNMA, Hearings, Vol. 1, March 27, 1990 at p. 459 (emphasis added).

16. Price Waterhouse, Independent Auditors' Report to the President of the Government National Mortgage Association, dated October 1990 ("Price Waterhouse Audit of GNMA") at Note E.

17. Price Waterhouse Consulting Report on Co-insurance at II-18.

18. Id.

19. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 1 regarding program losses), Hearings, Vol. 1, March 27, 1990, at p. 387.

20. Housing Study Group v. Kemp, Civil Action No. 90-0244 (D.D.C.)(Memorandum Opinion and Order, dated May 16, 1990, at 3).

21. Hearings (full Committee), September 28, 1989, Monroe at 414.

22. Peter Monroe, General Deputy Assistant Secretary, HUD, Hearings, Vol. 1, March 27, 1990 at p. 351.

23. Conversation between Clement Dinsmore, Counsel, HUD/Mod Rehab Investigation Subcommittee (together with other Banking Committee staff), and Larry Volk and Matt Andrea, staff of the U.S. Department of Housing and Urban Development, on March 14, 1990.

24. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 11 regarding program losses), Hearings, Vol. 1, March 27, 1990, at p. 419.

25. U.S. Department of Housing and Urban Development, Co-insuring Lender Letter No. 89-4, dated May 5, 1989.

26. Hearings (full Committee), September 28, 1989, Monroe at 398.

27. U.S. Department of Housing and Urban Development, Interim rule regarding Additional Review Requirements for HUD Co-insurance Programs, 55 F.R. 11342, 11343 (March 27, 1990)("HUD Pre-commitment Review Rule").

28. Id. at 11343.

29. HUD Co-insurance Program Termination Rule, 55 F.R. at 11333 (March 27, 1990).

30. Id. at 11334 (March 27, 1990).

31. Housing Study Group v. Kemp (see endnote 20).

32. HUD Co-insurance Program Termination Rule, 55 F.R. at 11334 (March 27, 1990).

33. Alfred Dellibovi, Under Secretary, HUD, Hearings, Vol. 1, March 27, 1990 at p. 438 (emphasis added).

34. HUD Pre-commitment Review Rule at 11344 (March 27, 1990).

35. Id.(emphasis added) (March 27, 1990).

36. U.S. Department of Housing and Urban Development, Office of Inspector General, Report on Audit of the Section 223(f) Co-insurance Program, dated December 9, 1988 ("December 1988 HUD IG Report") at 13.

37. Conversation between Clement Dinsmore and Larry Volk and Matt Andrea on March 14, 1990; Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 5 regarding implementation failures), Hearings, Vol. 1, March 27, 1990 at p. 381; Hipps Prepared Statement at p. 476.

38. Thomas Craren, Partner, Price Waterhouse, Hearing, Vol. 1, March 27, 1990 at pp. 433-34.

39. Price Waterhouse Consulting Report on Co-insurance at I-3.

40. HUD Pre-commitment Review Rule, 55 F.R. at 11344 (emphasis added) (March 27, 1990).

41. U.S. Department of Housing and Urban Development, Co-insurance for Mortgage Lenders (Section 223(f)), Handbook 4566.1 REV 1 (January 1984) ("Section 223(f) Program Handbook") at 2-2; Co-insurance for Mortgage Lenders (Section 221(d)), Handbook 4561.1 (June 1985) ("Section 221(d) Program Handbook") at 2-2.

42. Id.

43. HUD Summary of Co-insurance Programs (see endnote 3) at 7.

44. Price Waterhouse Consulting Report on Co-insurance at II-22.

45. Id. at III-41.

46. Id. at II-16-17.

47. Id. at II-10.

48. Prof. Robert Edelstein, Hearings, Vol. 1, March 27, 1990 at pp. 435-36. Under the co-insurance programs in addition to the 2% financing fee the lender collected an application fee of 30 basis points, a placement fee of 150 basis points, and in certain circumstances an inspection fee.

49. HUD Pre-commitment Review Rule, 55 F.R. at 11345 (March 27, 1990).

50. Price Waterhouse Audit of FHA, GAO Report on FHA Fund at 20.

51. Dale at p. 428 (emphasis added).

52. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 3 regarding the program implementation failures), Hearings, Vol. 1, March 27, 1990 at p. 363.

53. Hearings (full Committee), September 27, 1989, Bowsher at 38.

54. Beasley Prepared Statement at p. 484; Dale at p. 428.

55. Section 223(f) Program Handbook at Chapter 2; Section 221(d) Program Handbook at Chapter 2.

56. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 1 regarding program implementation failures), Hearings, Vol. 1, March 27, 1990 at p. 361.

57. Price Waterhouse Consulting Report on Co-insurance at III-42.

58. Dale at p. 429.

59. H. Rept. 93-1114, 93rd Cong. 2d Sess. (June 17, 1974) at 28.

60. 24 C.F.R. Section 251.815-251.818; 24 C.F.R. Section 252.815-252.818; 24 C.F.R. Section 255.815-255.818 (1990).

61. 24 C.F.R. Sections 251.818, 252.818, and 255.818 (1990).

62. Warren Lasko, Executive Vice President, MBA, Hearings, Vol. 1, March 27, 1990 at p. 345.

63. December 1988 HUD IG Report at 15; Beasley Prepared Statement at p. 485.

64. December 1988 HUD IG Report at 15.

65. Memorandum from the Housing Study Group to the U.S. Department of Housing and Urban Development, dated May 1, 1989 ("Housing Study Group May 1, 1989, Memorandum"), at 3 (emphasis added).

66. George Hipps, Senior Vice President, PW Funding, Hearings, Vol. 1, March 27, 1990 at 338.

67. Hipps Prepared Statement at 471.

68. HUD Pre-commitment Review Rule, 55 F.R. at 11344(March 27, 1990).

69. Chris Greer, Assistant Inspector General for Audit, HUD, Hearings, Vol. 1, March 27, 1990 at 439.

70. Dale at 341.

71. Dale at 341; Hipps at 341.

72. Hearings (full Committee), September 27, 1989, Bowsher at 13 (emphasis added).

73. Id. at 19 (emphasis added).

74. Id. at 34 (emphasis added).

75. Id. at 34.

76. Hearings, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, September 13, 1989, Duquette at 323.

77. Id.

78. Price Waterhouse Audit of FHA, GAP Report on FHA Fund at 12.

79. Hearing (full Committee), September 27, 1989, Fitts at 74.

80. Price Waterhouse Audit of FHA, GAO Report on FHA Fund at 20.

81. Letter from Ronald Poe, President of the Mortgage Bankers' Association, to HUD Secretary Samuel Pierce, dated July 8, 1986.

82. Beasley Prepared Statement at p. 487.

83. Hipps Prepared Statement at p. 476.

84. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 5 regarding program implementation failures), Hearings, Vol. 1, March 27, 1990 at p. 381.

85. Id.

86. Id.

87. Price Waterhouse Consulting Report on Co-insurance at III-62.

88. Id. at III-58.

89. Id. at III-64.

90. Id. at III-65-66.

91. Id. at III-69, III-75.

92. Affidavit of John M. Laird, Vice President and General Counsel, Centennial Mortgage, Inc., dated February 2, 1990, filed in Housing Study Group v. Kemp (see endnote 20), at 8.

93. Housing Study Group v. Kemp, Civil Action No. 90-0244, Memorandum Opinion and Order, dated February 5, 1990, at 5.

94. Conversation between Clement Dinsmore and Lawrence Volk, Daniel Railey, Richard Lasner, and David Cooper, representing HUD, on March 23, 1990.

95. Price Waterhouse Audit of FHA, GAO Report on FHA Fund at 41.

96. U.S. Department of Housing and Urban Development, Office of Inspector General, Multifamily Housing, Internal Audit of the Section 223(f) Co-insurance Program, Dated, November 5, 1985 ("November 1985 HUD IG Report") at 12.

97. Conversation between Clement Dinsmore and Thomas Craren, Price Waterhouse, on February 28, 1990.

98. December 1988 HUD IG Report at 11.

99. Id. at 13.

100. Id. at 11-12.

101. Hearings (full Committee), September 28, 1989, Monroe at 397.

102. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 4 regarding program implementation failures), Hearings, Vol. 1, March 27, 1990 at p. 380.

103. December 1988 HUD IG Report at iii.

104. Conversations between Clement Dinsmore and George Hipps, PW Funding, on February 9 and 15, 1990.

105. Dale at p. 428.

106. Price Waterhouse Audit of GNMA, Note E.

107. Hearings, Subcommittee on Employment and Housing, Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, November 16, 1989 ("House Banking November 16, 1990, Hearings"), Kalish at 3.

108. 24 CFR Sections 251.824,251.827;252.824,252.827; and 255.824,255.827 (1990).

109. 24 CFR Sections 251.827, 252.827, and 255.827 (1990).

110. 24 CFR Sections 251.827, 252.827, 255.827, and 207.259 (1990).

111. Memorandum of Understanding between the Assistant Secretary for Housing-FHA Commissioner and the Government National Mortgage Association regarding GNMA Management of DRG Funding Corporation's Co-insured Mortgage Portfolio, executed by FHA on February 3, 1989, and by GNMA on February 2, 1989, at 4, paragraph B.2..

112. Id. at 3-4, paragraph A.7.

113. Id. at 5, paragraph B.3.

114. House Banking November 16, 1990, Hearings (see endnote 106), Kalish at exhibit B.

115. Conversation between Clement Dinsmore and Lawrence Volk, Daniel Railey, Richard Lasner, and David Cooper, representing HUD, on March 23, 1990.

116. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 4 regarding program losses), Hearings, Vol. 1, March 27, 1990 at pp. 400-401.

117. Price Waterhouse Audit of GNMA, Note F.

118. Price Waterhouse Audit of FHA, GAO Report on FHA Fund at 11.

119. Conversation between Clement Dinsmore and Thomas Craren, Price Waterhouse, on February 28, 1990; Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 7 regarding program losses), Hearings, Vol. 1, March 27, 1990 at pp. 409, 411.

120. Conversation between Clement Dinsmore and Kimberly Neideffer of the Government National Mortgage Association staff on July 24, 1990.

121. Monroe at p. 349.

122. Craren at pp. 433, 447.

123. 12 U.S.C. Section 1735d(b).

124. 12 U.S.C. Section 1735c(f).

125. Craren at p. 449.

126. Id. at p. 449.

127. Id. at p. 447; Dale at p. 450.

128. 24 C.F.R. Sections 251.818, 252.818, and 255.818 (1990).

129. GNMA Mortgage-backed Securities Guide at Sections 16-10 and 16-11.

130. U.S. Department of Housing and Urban Development, Co-insuring Lender Letter No. 90-4, dated May 2, 1990.

131. Housing Study Group May 1, 1989, Memorandum (See endnote 64).

132. U.S. Department of Housing and Urban Development, Co-insuring Lender Letter No. 90-4, dated May 2, 1990.

133. Recently enacted Housing legislation alters HUD's duties under Section 203. The bill passed by the House of Representatives amended Section 203 by not requiring HUD to provide financial assistance pursuant to Section 203(d) with respect to vacant units in multifamily projects that are neither subsidized nor formerly subsidized. The bill also altered HUD's duties with respect to projects that are not subsidized or formerly subsidized by mandating that HUD provide Section 8 tenant-based voucher or certificate assistance to the eligible tenants of such projects. S. 566, 101st Cong. 2d Sess., as passed by the House, at Section 553. 136 Cong. Rec. at H6496 (No. 102-Part II, August 1, 1990) The Senate bill contained no comparable provision. The Conference Report included the House amendment. H.Rept. 101-922, dated October 22, 1990, at Section 579, 136 Cong. Rec. at H11567 (No. 145 - Part III, October 22, 1990).

134. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to questions 4 and 10 regarding program losses), Hearings, Vol. 1, March 27, 1990 at pp. 400, 418.

135. 12 U.S.C. Sections 3701-3717.

136. Gaye Beasley, Member, Board of Governors, MBA, Hearings, Vol. 1, March 27, 1990 at p. 450; Dale at p. 450; Letter from Ann Hadley vom Eigen, Associate Legislative Counsel, Mortgage Bankers Association of America, to Chairman Bob Graham, dated April 13, 1990.

137. See endnote 58.

138. Housing Study Group May 1, 1989, Memorandum (see endnote 64) at 3-4.

139. Response by U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 8 regarding program losses), Hearings, Vol. 1, March 27, 1990 at p. 416.

140. 12 U.S.C. Section 1715z-4.

141. 12 U.S.C. Section 1715n(a)(7).

142. 12 U.S.C. Section 1715n(d).

143. 12 U.S.C. Section 1715z-6.

144. Edelstein Prepared Statement at p. 555.

145. Beasley at p. 451; Conversations between Clement Dinsmore and Steven Gardiner, representing the Housing Study Group, on February 14-15, 1990.

146. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 9 regarding program losses), Hearings, Vol. 1, March 27, 1990 at p. 417.

147. Response of U.S. Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 7 regarding program implementation failures), Hearings, Vol. 1, March 27, 1990 at p. 385.

148. Id.

149. Price Waterhouse Consulting Report on Co-insurance at III-39 (emphasis added).

150. HUD Co-insurance Program Termination Rule, 55 F.R. at 11334 (March 27, 1990.

151. Price Waterhouse Consulting Report on Co-insurance at III-53.

152. Id. at III-55

153. Id. at III-75.

154. Id. at III-75.

155. Id. at III-76 (emphasis added).

156. Id. at III-71.

157. Price Waterhouse Audit of FHA, GAO Report on FHA Fund at 2.

158. Dale at p. 427.

159. Edelstein Prepared Statement at p. 548.

160. Id. at p. 549.

161. Id. at p. 553.

162. Dale Prepared Statement p. 504.

163. Dale at p. 427.

164. Conversation between Clement Dinsmore and Larry Dale, Fannie Mae, on June 20, 1990. This conversation preceded the termination of York Associates, Inc. as an issuer of GNMA-guaranteed securities on July 13, 1990, which may affect York's ability to service its loans under FNMA's DUS Program.

165. Dale Prepared Statement at p. 500.

166. Federal National Mortgage Association, Delegated Underwriting and Servicing Guide (May 1988, as updated) ("FNMA DUS Program Guide") at Part VII.

167. FNMA DUS Program Guide at Part IX.

168. Id.

169. FNMA DUS Program Guide at Part II.

170. Dale at p. 429.

171. Hipps at p. 338.

172. Hipps Prepared Statement at p. 477.

173. Hearings (full Committee), September 27, 1989, Fitts at 83.

174. Id. at 79.

175. PD&R Options Paper (see endnote 8).

176. Beasley Prepared Statement at p. 489.

177. Section 328 of the Conference Report, H.Rept. 101-922, dated October 22, 1990, 136 Cong. Rec. at H11535-36 (No. 145 - Part III, October 22, 1990). See also the Report of the House Committee on Appropriations on H.R. 5158, H.Rept. 101-556, 101st Cong. 2d Sess. at 36 (June 26, 1990).

178. Id.

179. HUD Co-insurance Program Termination Rule, 55 F.R. at 11334 (March 27, 1990).

180. Dale at p. 429.

181. Beasley Prepared Statement at p. 483.

182. For example, see Sections 221(d) and 232 of the National Housing Act, 12 U.S.C. Sections 1715l(d) and 1715w.

183. Response of U.S.Department of Housing and Urban Development, dated May 25, 1990, to Subcommittee's questions. (See response to question 7 regarding program implementation failures), Hearings, Vol. 1, March 27, 1990, at p. 385.

184. Id.

185. Dale at p. 450.

186. Section 244 of the National Housing Act, 12 U.S.C. Section 1715z-9.

187. Conversations between Clement Dinsmore and George Hipps, PW Funding, on February 9 and 15, 1990.

188. Price Waterhouse Audit of FHA, GAO Report on FHA Fund at 11; 12 U.S.C. Section 1735c.

189. Id.

CHAPTER FOUR
LOW INCOME HOUSING TAX CREDIT
SUMMARY

The low income housing tax credit that is available under Section 42 of the Internal Revenue Code has become the principal Federal subsidy supporting the production of low income housing. The credit is usually combined with Federal, State, or local non-tax subsidies. The Congress last year extended the credit's availability until December 31, 1989, and substantially amended the credit authority to increase the role and responsibility of housing credit agencies in allocating credits efficiently and to projects that addressed housing needs of low income families. The Congress in separate legislation in 1989 also mandated that HUD and the Farmers Home Administration take account of the tax credit and other forms of assistance when providing assistance within their respective authority to housing projects. HUD and Farmers Home have issued proposed or interim regulations implementing this new directive.

The 1989 legislation did not resolve all issues. Significant issues that require resolution include:

-- the timing of credit allocation actions by housing credit agencies relative to the timing of HUD or Farmers Home Administration awards of non-tax subsidies;

-- the need for expeditious action by HUD in implementing its new responsibilites under the 1989 HUD reform legislation;

-- the need for a longer term extension of the credit authority to encourage greater investor interest in credit-assisted projects and to encourage housing credit agencies to develop in-house capacity to perform their new responsibilities;

-- the continued possibility that non-tax subsidies, such as Section 8 tenant-based rental assistance payments, can provide project developers with potential windfalls;

-- the need for clarification of the role of the housing credit agencies in monitoring developers' compliance with the credit program's terms; and

-- the need for greater accountability of the housing credit agencies for the housing production results of the credit program, including the success of the program in meeting acute housing needs of low income families.

CHAPTER FOUR
LOW-INCOME HOUSING TAX CREDIT

I. Introduction

A. Reason for Subcommittee Inquiry

In connection with its investigation of HUD's Section 8 Moderate Rehabilitation program the full Banking Committee considered project developers' use of the low income housing tax credit together with Section 8 assistance to finance projects. The layering of tax and non-tax subsidies produced in instances noted windfall returns to developers. The full Commmittee conducted hearings on these subjects on August 2 and September 29, 1989.

Subsequently, the Congress enacted both tax and housing legislation[1] that addressed certain issues considered at the hearings, including specifically whether tax credits and Section 8 Moderate Rehabilitation program subsidies should be available to the same project.

The layering of tax and non-tax subsidies to finance housing projects raises a host of policy and technical, legal issues. As the legislation enacted last year did not dispose of all such issues and raised some new ones, the Subcommittee determined to study the 1989 legislation and its implementation and to consider issues not fully resolved by such legislation.

B. Basic Terms of the Low Income Housing Tax Credit

In order to facilitate an understanding of the subsequent discussion of issues considered by the Subcommittee a brief introduction of certain, key terms of the low income housing tax credit follows.

(1) Intended Beneficiaries

The low income housing tax credit helps finance housing projects that benefit persons whose income is sixty percent or less of area median gross income. To qualify for the credit either twenty percent or more of a project's units must be occupied by persons whose income is fifty percent or less of area median gross income, or forty percent or more of the units must be occupied by persons whose income is sixty percent or less of area median gross income. A project owner must irrevocably elect to meet one of these tests. Rental household income is adjusted for family size in a manner similar to the adjustments made under HUD's Section 8 rental assistance program.[2] As the

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average income of a renter is between 50 and 60 percent of area median gross income, the credit targets persons in the rental household population.[3]

A credit-assisted unit will continue to qualify for the credit even if the tenant household income increases by up to 140%.[4] If the income increases by more than 140%, then the unit will continue to qualify only if the next vacant comparable unit is occupied by a family that meets the required income limitation.

(2) Limitation on Rents of Occupied Units

In addition to targeting the beneficiaries the tax credit requires that the gross rent charged for each unit occupied by the intended beneficiaries be restricted to thirty percent or less of the household income that is imputed to the unit. Significantly, gross rent does not include rental assistance payments under HUD's Section 8 program or any comparable program.[5] The imputed household income is based upon a rental unit's number of bedrooms and an assumption that 1.5 individuals occupy each bedroom. Thus, if a unit had two bedrooms, the household size is assumed to be a family of three regardless of actual family size. The imputed family income is then determined by reference to the family income determination for a family of three under HUD's Section 8 program.[6]

The credit's rental restriction provisions are designed to assure that credit-assisted units in a project are occupied by the intended beneficiaries. The credit's benefit is expected to help enable the project owner to offer units at lesser rents. "In return for providing housing at reduced rents, owners of rental housing receive a tax credit designed to compensate them for the rent reduction."[7]

(3) Types of Housing That May Be Assisted

The types of housing that may be assisted by the credit are not limited to multifamily housing. They include single-family detached homes, attached townhouses, four unit apartment buildings, and complexes of buildings with hundreds or thousands of units.[8] Special rules and limitations apply to buildings with four or fewer units that are owned by an occupant of one of the units.[9]

This broad range of eligible housing provides great flexibility in the delivery of the credit subsidy to families in urban, suburban, and rural areas.

The common requirement for all such housing is that it be "suitable for occupancy."[10] The Secretary of the Treasury determines suitability after "taking into account local health, safety, and building codes."[11]

(4) Amount of the Credit

The amount of the credit varies with certain factors. First, new buildings that are not "federally subsidized" may qualify for the 9% credit that enables the building owner to receive a credit over a ten year period that has a present value of 70% of certain qualifying costs of the building. New buildings that are "federally subsidized" and existing buildings may qualify for the 4% credit that enables the owner to receive a credit over the same period with a present value of 30% of such costs.[12] "Federally subsidized" for this purpose means a building the acquisition, construction, or operation of which is financed in part with tax-exempt bonds or a below market rate Federal loan.[13] The latter type of loan does not include a loan funded with monies received under HUD's Community Development Block Grant program.[14] A "new building" is a building "the original use of which begins with the taxpayer."[15] An "existing building" is any building that is not a new building.

Second, the credit will vary with the amount of the eligible costs that may be included in the tax basis of the building.

Third, the credit will vary with the extent to which the units in the building are devoted to occupancy by the intended tenant beneficiaries of the credit.[16] If the low income occupancy of a building varies as of the end of a taxable year during the ten year period in which the credit may be taken[17], the amount of the credit available from year to year will vary accordingly.

Fourth, as the credit may only assist rental units that are "suitable for occupancy," the credit will vary, if units cease as of the end of any taxable year to meet this requirement and then are brought back into compliance in a subsequent taxable year.

(5) Property Use Restrictions; Recapture Liability

Eligibility for the tax credit requires that the project owner execute with the appropriate housing credit agency an agreement in which the owner commits to maintain low income tenant occupancy to the extent specified in the agreement for a period that is not less than fifteen years and may extend for up to thirty years or longer.[18] Such an agreement is enforceable by the housing credit agency and persons who qualify as eligible tenants under the occupancy requirement, is recorded as a deed restriction, and is enforceable against the taxpayer's successors.

The tax credit provisions contemplate that its benefit may be received over a ten year period, while the accompanying economic burdens or restrictions extend for at least fifteen years.

Sanctions for non-compliance with the occupancy, habitability, or other continuing requirements of the credit include recapture of the "accelerated portion" of the credit, i.e. that amount of the credit that the taxpayer has received by reason of the credit's benefit being available within a ten rather than fifteen year period.[19]

(6) Temporary Availability of Tax Credit; Aggregate Available Credit

In the absence of further amendment the tax credit will cease to be available after December 31, 1990.[20] Furthermore, Congress has allowed an aggregate credit for 1990 that is only 75% of the otherwise allowable total credit.[21]

II. Role and Efficiency of Tax Credit In Financing The Production of Low Income Housing

A. Production Results

Since enactment of the Tax Reform Act of 1986 the tax credit has become the principal Federal subsidy in support of the production of housing for low income families. It has replaced direct, non-tax subsidies, as utilization of the credit has increased substantially since 1987 and appropriations for Federal non-tax subsidy programs have declined drastically during the last decade. In 1987 20% of available credits was used to assist more than 34,000 units. Approximately 42% of these units were new construction units, and 32% were substantial rehabilitation units. In 1988 the credit utilization rate increased to 67%, and 77,825 units were assisted. New construction increased to 44% of the total, and substantial rehabilitation declined to 26% of the total. In 1989 virtually all (98%) of the available credits were used to assist approximately 125,000 units. New construction increased to 50% of the total, and substantial rehabilitation declined to 21%.

The approximately 125,000 units produced in 1989 compares favorably with the 158,000 units produced under HUD's Section 8 New Construction and Substantial Rehabilitation program in 1978, the peak production year for that program.[22] The aggregate initial year tax credit used to finance these 125,000 units totaled almost $300 million.

For the three years, 1987-1989, tax credits had been allocated to assist 236,000 housing units. The estimated cost to the United States Treasury of use of these credits during their full benefit period is $5.7 billion.[23]

B. Use of Tax Credit With Non-Tax Subsidies

The tax credit subsidy has been combined with non-tax subsidies to finance the acquisition, construction, or rehabilitation of credit-assisted projects. Available data for the years 1987 and 1988 indicate that approximately 62% of the projects received other Federal, non-tax subsidies, and 75% of the projects received other Federal, State, or local subsidies.[24]

Sometimes the combination of subsidies has produced windfalls to the project developer or its investors. Dramatic examples of windfalls have occurred, when credit projects have received rent subsidies under HUD's Section 8 Moderate Rehabilitation program.[25] HUD data indicate that during 1987-88 there were 224 projects with over 12,000 units that received both tax credit and Mod Rehab subsidies.[26] The percentage of total credit-assisted units that received Mod Rehab subsidies declined from 15% to 8% during this two year period.[27]

Frequently, however, the combination of subsidies is necessary in order to deliver affordable housing to the tenant population that qualifies for occupancy of credit-assisted units. The issue becomes not whether multiple subsidies should be combined but how much needs to be combined.[28] As construction or rehabilitation costs increase and area median gross income declines, the tax credit alone becomes a less adequate or inadequate subsidy, because the household income and rent payment requirements applicable to assisted units establish a limit on income to the project owner that is below allocable project costs. New York City illustrates the areas where the combination of high construction costs and low area median gross income makes the tax credit alone insufficient to finance housing for the targeted rental households. States such as Florida, on the other hand, where construction costs are lower and area median gross income is higher, are more likely to require reduced levels of non-tax subsidies.[29]

C. Efficiency of Tax Credit As A Subsidy Delivery Mechanism

The tax credit enables project developers to induce equity investment in low income housing projects. The relative success or efficiency with which this is accomplished varies significantly. There are a host of factors that affect the amount of equity capital that developers are able to raise, when they syndicate (or sell) limited partnership interests in credit-assisted projects.

The net equity raised will vary with investors' perceptions of the risks associated with the project. The higher the risk is perceived, the greater is the rate of return demanded. As the rate of return that may be realized is principally determined in most projects by the amount of tax benefits that will be received by the investor[30], the net equity raised is reduced by the demand for a higher rate of return.[31]

Factors that affect investors' perceptions of project risk include availability of other subsidies[32], "project location, financial stability and track record of the sponsors, project design, mortgage loan financing terms and general market conditions."[33] Project risk, also, is affected by the term of the low income housing use restriction that applies to the project. A longer use restriction increases risk by delaying project sale and return of capital that is premised on such sale. "A very safe project, one with a long term project based subsidy, could command approximately ten to fifteen percent greater capital contribution than a project without this level of safety."[34]

The availability of long term mortgage financing affects project risk. If, as is true under current conditions, such long term financing is difficult to obtain, the cost of debt financing is greater, and project expenses and risk increase. Or, if a reduced amount of debt financing is made available, the demand for--and cost of--equity capital increases. The current lack of alternative debt financing methods is an acute problem today that jeopardizes the efficient use of the tax credit.[35]

The impermanence of the tax credit itself, also, creates a risk for which investors, particularly corporate investors, demand a greater return.[36]

The availability of alternative investments, particularly for corporate investors, is another factor that affects the rate of return demanded.[37]

The equity capital raised through syndication depends further upon whether interests are being sold to individuals or corporations. Non-profit developers raise funds principally or exclusively from corporate investors. For-profit developers raise funds principally but not exclusively from individual investors. The "passive loss" rules under the Internal Revenue Code affect the amount of capital that can be raised from each individual investor. These rules determine the amount of losses attributable to "passive activities" (that include investments in real estate limited partnerships) that an individual may deduct. They effectively limit the tax credit that an individual can use in any one year to $8,250.[38] This limitation in turn reduces the amount of capital that any one individual will contribute to a credit project and requires a public solicitation of investors in order to attract substantial capital. Public solicitation imposes Federal and State securities registration expenses as well as substantial securities brokerage expenses on developers that seek capital from individual investors.[39]

Because corporate investors are not subject to the "passive loss" rules, larger amounts of capital can be raised from them through direct placements (non-public sales) with one or a few investors. In addition to the tax credit corporations, also, are able to use other "passive" tax benefits such as "depreciation allowances and interest deductions not available to individuals."[40] The direct placement of the partnership interests with corporate investors avoids the securities registration and brokerage expenses incurred in sales to individuals.[41] These distinctions reduce transaction costs as a percentage of capital raised from a range of 21% to 26.5% (in the case of sales to individuals) to a range of 8% to 15% (in the case of sales to corporations).[42]

Partially offsetting this reduction of transaction costs is the demand of corporate investors for a higher rate of return, which reduces the net capital raised from the credit sale.[43] Furthermore, most corporate investors make their capital contributions over a six to seven year period. This ususally requires the developer to arrange some form of "bridge financing" while the capital is being paid.[44]

III. Evolution of the Tax Credit Program And Its Use With Other Subsidies

In 1989 the Congress extended the tax credit's availability for another year. In doing so it reviewed the data available from 1987 and 1988 regarding the use of the credit and determined to make changes in the tax credit's provisions that addressed both the issue of combining tax and non-tax subsidies in a single project and the issue of the credit's efficiency in generating equity capital. At the same time and by separate legislation Congress determined to impose upon HUD and the Farmers Home Administration new duties to consider the efficiency of allocation of Federal non-tax subsidies to tax credit projects.

Congress recognized the distinction in complexity between HUD's and Farmers Home's tasks in implementing their new duties. Congress imposed a six month deadline upon issuance of regulations by Farmers Home but allowed HUD to determine the effective date of implementation of its duties.

However, in imposing new underwriting responsibilities upon HUD Congress may not have adequately anticipated the capacity of the agency to perform those responsibilities and the ramifications of HUD's capacity problems on the implementation of the tax credit program. The agency's lack of adequate capacity has severely disrupted the ability of the housing credit agencies to allocate tax credits in 1990 to projects that contemplate assistance from HUD of the type that falls within HUD's new underwriting duties.

A. New Duties of the Housing Tax Credit Agencies and Their Potential Implication

The Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, substantially amended the tax credit authority, Section 42 of the Internal Revenue Code. The amendments included a new requirement that housing credit agencies allocate their available credits pursuant to an allocation plan that sets forth project selection criteria and priorities. These include granting:

> the highest priority to those projects as to which the highest percentage of the housing credit dollar amount is to be used for project costs other than the cost of intermediaries unless granting such priority would impede the development of projects in hard-to-develop areas....[45]

Priority is also accorded projects that serve the lowest income tenants and projects that serve qualified tenants for the longest periods.[46] Mandatory selection criteria include "housing needs characteristics" and "tenant populations with special housing needs".[47]

In addition, the 1989 amendments imposed an underwriting duty upon the housing credit agencies that requires that:

> [t]he housing credit dollar amount allocated to a project shall not exceed the amount the housing credit agency determines is necessary for the financial feasibility of the project and its viability as a qualified low-income housing project throughout the credit period.[48]

This underwriting determination is to be made at three separate times: (i) as of application for the credit, (ii) as of initial allocation of the credit, and (iii) as of the date the project is "placed in service" (or ready for occupancy).[49] Prior to each such determination the project sponsor or developer must certify to the housing credit agency the other Federal, State, and local subsidies that the developer expects to be made available to the project.[50]

In Florida and many other States the housing credit agencies have developed implementing procedures that contemplate a three step process. Step one is a competitive scoring process by which developers' applications are ranked. Florida's process rewards those applications that ask for fewer credits.[51] Step two involves a full credit underwriting evaluation based upon project pro formas to determine the reasonableness of estimated costs and revenues and the amount of credit-induced equity that is needed for project feasibility. Step three is a final credit underwriting evaluation based upon actual costs incurred to place the project in service.[52]

The 1989 amendments that establish these new allocation and underwriting requirements are expected to increase the competition for credit allocations among project developers and syndicators. As non-profit project sponsors and State-sponsored equity funds enjoy an advantage over for-profit project sponsors in their syndication costs, the increased competition is expected to put pressure on the for-profit sponsors and syndicators to reduce such costs.[53] However, such a reduction is not expected to exceed 5% of the project capital raised.[54]

The increased competition for the limited supply of available credits, also, is expected to reduce rates of return that project developers must pay to induce investor interest. The 1989 amendments create incentives for developers to obtain as much net equity capital as possible from the credits allocated to them, because the State agencies will give priority to those projects that demand a smaller credit allocation.[55] As explained earlier, the net equity capital raised from a credit syndication increases, as the rate of return paid the investor declines.

Another probable consequence of the 1989 amendments is the use of the credit where it is most needed to induce the construction of low income housing. Mark Hendrickson, Executive Director of the Florida Housing Finance Agency, speaking on behalf of the National Council of State Housing Agencies, indicated at the Subcommittee's April 27, 1990, roundtable discussion:

> [O]ur credit underwriting will be such that if we look at the project, and it is financially feasible without a tax credit, they won't get one.
>
> So the projects that would and could be built without the tax credit subsidy won't be given a tax credit subsidy.[56]

Notwithstanding the 1989 amendments, certain factors continue to inhibit the full realization of the potential benefits of the amendments. These include the impermanence of the credit itself and the acute shortage of long term mortgage funding sources. As noted earlier, the funding shortage increases project risk. Also as noted, the impermanence of the credit creates additional risk that reduces investment of equity capital and increases the rates of return that investors demand. The impermanence of the credit as well as certain other features of the tax credit further discourage the participation of more housing developers in the credit program.[57] This reduced participation dampens the competition for the available credits that the 1989 amendments are designed to encourage.

B. New Duties of HUD and the Farmers Home Administration With Respect to Non-Tax Subsidies That May Be Combined With the Tax Credit

The Department of Housing and Urban Development Reform Act of 1989, P.L. 101-235 ("HR 1"), requires HUD and the Farmers Home Administration to perform an underwriting analysis of applications for their respective non-tax subsidies that mirrors the credit underwriting analyis that the housing credit agencies must perform pursuant to the 1989 amendments to the tax credit.

Section 102(d) of HR 1 imposes on HUD, with regard to future applications for any HUD assistance to a housing project , a duty to grant only that amount of assistance "necessary to provide affordable housing" after considering the amounts of subsidies that the applicant will obtain from other sources, including the low income housing tax credit. This duty becomes effective following HUD's publication of regulations implementing Section 102.[58]

Section 102(b) separately mandates the disclosure to HUD or any State or unit of general local government by an applicant for assistance to a project in an annual amount of $200,000 (or such lesser amount as the HUD Secretary may determine by regulation) of certain information relating to the project, including information regarding any other assistance from a Federal, State, or local governmental entity or agency that the applicant expects to be made available to the project or activities for which the applicant is seeking HUD support. Such other assistance specifically includes tax benefits. The applicant has an obligation to update its disclosures during the period of HUD's consideration of its application.[59]

Section 401 of HR 1 imposes a similar underwriting duty and disclosure requirement with respect to applications for assistance submitted to the Agriculture Secretary. These changes will affect the housing assistance programs of the Farmers Home Administration.

The Farmers Home Administration has issued an interim rule effective as of June 16, 1990, implementing its new duties under Section 401 of HR 1. The rule affects only the Section 515 Rural Rental Housing Program. It incorporates a loan processing procedure worked out with the National Council of State Housing Agencies. This procedure contemplates a three step process that parallels the credit allocation process that the housing credit agencies have developed. Significantly, the Farmers Home Administration has provided that its action will precede the credit agency action at each of the three steps. For example, Farmers Home will act on a loan preapplication prior to the credit agency acting on its initial competitive scoring process.[60] The credit agency will complete its second step of full credit underwriting after Farmers Home has completed processing of a full loan application, and the credit agency will make its final tax credit award calculation after the Farmers Home loan closing.[61]

HUD issued a proposed rule on June 19, 1990, implementing its new duties under Section 102 of HR 1. HUD's rulemaking is far more complicated and far less definitive than the Farmers Home rule. The rule's complexity is attributable to the far greater number and differences in types of subsidy programs to which it applies. The proposed rule provides an overall structure for administration of HUD's new duties but contemplates the later issuance of administrative instructions to resolve many implementation issues that are specific to the different programs that HUD has identified in the rule as subject to Section 102's different procedural requirements.

In its proposed rule HUD takes the position that Section 102's provisions requiring notice of agency assistance actions and documentation of assistance applications and agency actions apply to "discretionary authorities administered by the Department that provide assistance on a competitive basis."[62] HUD construes the applicant disclosure obligations of Section 102 to "apply to applications for assistance for specific projects or activities."[63] HUD concludes that Section 8 tenant-based assistance does not involve a "project or activity."[64] HUD adds a gloss to Section 102(d)'s underwriting duty by construing it to apply only to multifamily residential projects of five or more units.[65] HUD defers resolution of how Section 102(d) limits HUD assistance to a project.

> The Department believes that the question of the amount of assistance necessary to ensure a project's feasibility must be answered in the context of each covered program, and may well vary from project to project.... Administrative instructions would be issued as necessary for covered programs, specifying the details for implementing the statutory provision for specific housing projects.[66]

HUD states that it has retained an independent contractor to assist it in the implementation of Section 102.

> This contract will (1) provide for review and assessment of HUD's current program methodology for determining maximum HUD subsidy; (2) establish specific programmatic criteria for HUD to utilize in its subsidy evaluation process; and (3) create the quantitative techniques necessary to analyze and adjust the level of HUD subsidy, using computer application programs.[67]

Clearly, HUD contemplates further detailed study prior to implementation of its new duties.

HUD indicates further in its rule that in making its assistance determinations under Section 102(d) it will disregard other governmental assistance that has been "'used up'" prior to the application for HUD assistance.[68] While HUD's intent is somewhat ambiguous it appears to want to disregard other assistance that does not continue after the application for HUD assistance.

> With respect to tax credit subsidies HUD states as follows:
> The Department recognizes that many projects involve both HUD assistance and low-income housing tax credits, and that coordinated procedures are appropriate to minimize the burden on applicants requesting assistance from different sources. As the Department develops the administrative instructions to be issued pursuant to this rule, it will explore specific ways in which the two legislative mandates could be effectively coordinated for the various HUD assistance programs.[69]

This is as far as HUD goes in providing any assurance in the rule that it will attempt to avoid unduely complicating the procedures by which a project developer may obtain both tax credits and HUD non-tax subsidies.

The delay in HUD's rulemaking actions pursuant to Section 102 of HR 1 and the Department's substantial reliance upon an outside accounting firm to develop policy and procedures under Section 102 provide evidence that the agency lacks capacity to perform satisfactorily the new responsibility assigned to it. The Congress in enacting Section 102 may have not adequately considered this capacity issue.

C. Timing of State and Federal Agency Actions

Significantly, HUD's proposed rule, unlike that of the Farmers Home Administration, does not indicate the timing of HUD administrative actions relative to those of the housing credit agencies in allocating tax credits. Thus, the rule leaves unresolved the "chicken and egg" issue of which agency-the housing credit agency or the agency providing the direct subsidies-can rely on the action of the other in making its assistance decision.

Barton Harvey of The Enterprise Foundation emphasized at the Subcommittee's April 27, 1990, roundtable discussion the practical significance to developers of the resolution of the "chicken and egg" issue. He stated as follows:

> And it is very important to us and to the efficiency of this [tax credit] program that the state agencies and HUD determine who makes that last allocation decision, because if both of them are trying to figure out whether and what amounts are being awarded by each other, the poor person trying to develop in the middle is left not knowing what amount of subsidy they are going to get from anyone and who the final arbiter is and when that decision will finally come down.[70]

Mark Hendrickson, representing the housing credit agencies, concurred with this observation. He further stated that "[t]he last thing that we want is a bouncing back and forth and wasting a lot of time.... [F]rom our perspective, we will look at the tax credit as the last subsidy... and the one that would be reduced, if the other subsidies, in combination, would allow that to take place."[71]

James Logue, HUD Deputy Assistant Secretary for Multifamily Housing, expressed the view that the "chicken and egg" issue did not require further legislative action by the Congress.[72] He further stated that HUD intended to avoid "a duplicative process undertaken by both the credit allocating agencies and the Department."[73]

HUD's proposed rule published on June 19 does not provide comfort on this issue beyond a reiteration of Deputy Assistant Secretary Logue's statement of cooperative intention.

The "chicken and egg" issue does not disappear as long as different agencies reserve the right to fine tune the amount of assistance that they contribute to a project. Both the housing credit dollar amount and HUD subsidies are subject to adjustment, as a project moves from initial application to construction to placement in service. The issue is more manageable, if the adjustments are in fact a fine tuning and not a substantial change in commitments that requires a new analysis based on substantially changed assumptions. The more well-considered the initial commitments of assistance are, the more likely the issue will be manageable. A substantial problem for the credit agencies and project developers and investors is that HUD has yet to articulate through its administrative instructions under Section 102 the methodology by which it will determine its initial commitments of subsidies. Until HUD discloses that methodology the credit agencies will be at sea in making reliable assumptions regarding the assistance that HUD is likely to commit to a credit project.

In implementing Section 102 of HR 1 HUD needs to be sensitive to the timetable that the housing credit agencies contemplate as necessary to their allocation of tax credits. This is an particularly acute problem this year. Mark Hendrickson, speaking for the National Council of State Housing Agencies, stated as follows:

> [T]ime is of the essence. We are under the gun here to allocate tax credits and to come to closure.... We are going to be needing to make this credit need evaluation very quickly. It is going to be taking place in June and July and August of this year. So we need to have the system in place to meet that kind of timing. ... It is going to be important for HUD to have a quick turnaround. You know, the determination of need can't be something that takes a month or six weeks or two months for them to figure out.... And if ... HUD can't do a quick turnaround, I think that could be a tremendous impediment to the efficent use of [the] credit....[74]

William Haynsworth, speaking for project syndicators, concurred with this judgment in stating that he was "deeply concerned that HUD and the states effectively coordinate their responsibilities."[75]

RECOMMENDATION:

HUD must implement Section 102 of HR 1 in a manner that is well coordinated with the actions of the housing credit agencies in order to facilitate expeditious allocations of tax credits by the housing credit agencies and to achieve the objectives of the Act and the 1989 amendments to Section 42 of the Internal Revenue Code.

The Department must integrate into its Section 102 procedures requirements for timely action by the Department. If following 1991 (assuming extension of the tax credit) it appears that the Department's implementation of HR 1 is frustrating the implementation of the tax credit program, the Congress should amend HR 1 to reconcile the Department's procedures with those of the credit agencies.

Section 102 of HR 1 becomes effective as of the date specified by the HUD Secretary in implementing regulations. If HUD is likely to frustrate the initial approval and funding of tax credit projects this year by its delay in issuance of its administrative instructions that describe how and when the agency will take account of tax credits in determining the appropriate level of HUD assistance for housing projects, then it could elect to defer implementing such instructions until next year. Such deferral would avoid frustrating the credit agencies' allocation of tax credits for this year.

RECOMMENDATION:

If HUD is unable to implement timely its administrative instructions regarding the combination of HUD assistance with tax credits, then the Department should defer making such instructions effective until 1991.

D. Need For Additional Mandate to Credit Agencies to Control Project Distributions to Investors, When Tax Credit is Combined With Section 8 or Other Subsidy That Is Not Considered In Underwriting Calculations of the Housing Credit Agencies, HUD, Or Farmers Home Administration

The 1989 amendments to the tax credit and HR 1 do not prevent an excessive combination of subsidies in all cases. Section 8 tenant-based rent subsidies (that a project owner receives under a renewable one year contract only so long as the tenant elects to reside in the project) for example, illustrate the type of non-tax subsidy that the housing credit agencies will not take account of when allocating tax credits and HUD will not adjust under the requirements of HR 1.

Tax credits induce equity investment that is needed to pay for project costs that are not financed with mortgage debt (or other sources, such as grants).[76] Credit agencies, therefore, will allocate credits after taking account of the debt that lenders will underwrite. Lenders determine that amount based upon their assessment of a project's probable net operating income, which in turn depends upon the lenders' estimate of a project's probable rental income. Lenders do not determine mortgage amounts based upon Section 8 tenant-based subsidies, because such subsidies are not long term and are transportable.[77] Many, if not most, lenders also will disregard Section 8 project-based rent subsidies in determining the loan amounts they will underwrite, because the project owner has a contractual right to receive such subsidies for only a five year term.[78] Apparently, there is the possibility that some lenders may take account of project-based payments in determining the project loan amount.[79] If lenders disregard Section 8 subsidies, either tenant-based or project-based, or both, and the housing credit agencies determine the credit allocation in light of the mortgage amount, then there remains the risk that a project's investors will realize a higher rate of return or possible windfall from the project's receipt of Section 8 subsidies, if and to the extent that the Section 8 rent payments exceed actual market rate rents.

HUD, pursuant to HR 1's new underwriting requirements, intends to distinguish between tenant-based and project-based subsidies and take account of the tax credits allocated to a project in determining the Section 8 project-based rental assistance payments that a project may receive.[80]

Parties involved with the credit program recognize that a project may realize "surplus" cash flow from receipt of Section 8 subsidies. The Enterprise Social Investment Corporation, a syndicator of non-profit projects, regularly takes account of Section 8 tenant-based subsidies by structuring "some kind of a reserve fund for additional [project] expenses over time" that is funded with the Section 8 rental payments.[81]

Mark Hendrickson, speaking on behalf of the credit agencies with respect to the interplay between the tax credit and Section 8 programs, stated:

> Any portion of NOI [net operating income] related to rental assistance which does not go to pay debt service is considered project cash flow available for distribution to the owner. We are recommending to states that cash flow distribution be restricted on a percentage basis as a portion of equity based on performance. Any cash flow in excess of this allowed distribution would be placed in a residual receipts account controlled by the agency through the Extended Use Agreement [between the project developer and the credit agency]. These residual receipts could be used to augment operating reserves or replacement reserves in an emergency if the agency deems appropriate. If the owner wishes to sell the property at year 15, funds in the residual receipts could be used to finance the acquisition by a buyer willing to commit to low income use throughout the next 15 years.[82]

The credit agencies, pursuant to their new credit underwriting authority, have discretion to impose the type of restriction recommended by the National Council of State Housing Finance Agencies. It is too early to determine the agencies' response to the Council's recommendation and the effectiveness of that response. The agencies may develop alternative means of addressing the issue. These could include controls that affected rental income.

RECOMMENDATION:

The Congress should monitor closely whether and how the housing credit agencies control the use of project cash receipts from Section 8 rental assistance payments and other subsidy sources that (1) the credit agencies do not take account of in determining the credit allocation to a project and (2) HUD or the Farmers

Home Administration is not obligated to reduce in light of other assistance pursuant to the requirements of HR 1.

If it becomes apparent after 1991 (assuming an extension of the tax credit) that project distributions may need to be addressed more uniformly, the Congress should consider the need for further fine tuning of the tax credit's provisions.

Among the total project costs that must be financed is the project developer's fee. Credit agencies vary in the fee they permit.[83] The amount of the fee affects both the amount of the credit allocated to a project and the return realized by a project developer. The Congress should determine an appropriate rule regarding the distribution of project cash for the payment of the developer's fee.

RECOMMENDATION:

The Congress should establish the manner of determining the fee that may be paid to a credit-assisted project developer from project funds. If such statutory provision establishes a limit on the fee, it should permit the state credit agencies the flexibility to establish a more stringent limit.

E. Credit Agency Capacity to Implement New Duties

The 1989 amendments to the tax credit authority impose substantial responsibilities upon the housing credit agencies. The credit allocation determinations require an underwriting competence that the agencies may or may not possess. The agencies vary greatly in the technical expertise of their staffs.[84] This variation is illustrated by the differences among the agencies in their success in allocating their available credit authority. While the differences have narrowed between 1987 and 1989, there were a meaningful number of agencies that in 1989 did not allocate all of their authority.[85] Credit agencies differ in the scope of their housing assistance programs. Those States, like Florida, that either have State credit programs or experience in allocating credit under tax exempt bond programs, are most likely to possess the capacity to perform the new tax credit responsibilities.[86]

The credit agencies appear to have very small staffs devoted to the tax credit program.[87] Some States like Florida supplement in-house staff with private sector contractors.[88] The impermanence of the tax credit materially inhibits credit agencies from committing additional resources to the development of administrative capacity to implement the tax credit program. In 1990 the credit agencies are having to commit resources to administer a nine month program, because the credits allocated to the States were limited to 75% of the otherwise available authority. Mark Hendrickson, speaking on behalf of the credit agencies, stated as follows:

> So at some point there is a danger that the nine-month extension will cause the allocating agencies to be unable or unwilling to commit the resources that we need to build up our staff infrastructure to do these things when we have a program that could disappear at the end of this year.[89]

Mr. Hendrickson indicated that a permanent extension of the tax credit would be desired and an extension for fewer than two or three years would frustrate credit agency administration of the credit program.[90] The minimum two to three year period takes account of the long lead time that is required for developers to organize low income housing projects.

RECOMMENDATION:

The Congress should take account of the effect of one year extensions of the tax credit authority upon the capacity of housing credit agencies to administer the tax credit program and should grant an extension that is not less than three years.

IV. Monitoring The Implementation Of The Tax Credit Program And Developers' Compliance With the Program's Terms

A. Need to Clarify the Role of Housing Credit Agencies in Monitoring Developers' Compliance With the Program's Terms

The 1989 amendments to the tax credit authority include a provision that requires that the credit allocation plan provide "a procedure that the agency will follow in notifying the Internal Revenue Service of noncompliance with the provisions of this section [42] which such agency becomes aware of."[91] The Conference Report on the Omnibus Budget Reconciliation Act of 1989 states:

> The conferees also intend that if an allocating agency becomes aware that a project is not in compliance, the agency shall report this noncompliance to the IRS.[92]

This requirement contemplates a "passive" rather than "active" role for the credit agencies in determining non-compliance.

As noted earlier in the introductory discussion of the tax credit, the credit is a long-term assistance program in which the benefit is received in ten years and the economic restrictions or burdens extend for a minimum fifteen year period. Also, the credit's continuing availability to the project investors depends upon compliance with the program's requirements. These include the tenant occupancy and rent restriction requirements that are determined by tenant income and the habitability requirements that are determined by the Treasury Secretary after taking account of local codes.

The long-term nature and complexity of the tax credit program present an herculean enforcement task for the Internal Revenue Service. While the Service expects to establish monitoring procedures that rely upon matching data received from the credit agencies with data received from the project owners/taxpayers[93], its system of enforcement of the tax credit provisions, as with the Internal Revenue Code generally, depends upon self-interested, voluntary compliance.

Project developers and syndicators do have a self-interest in compliance with the credit's terms. William Haynsworth, Senior Vice President, The Boston Financial Group Inc., a major syndicator of interests in for-profit projects, noted:

> It is industry practice for investment partnerships to provide for potentially severe penalties against project general partners in the event of non compliance with statutory requirements. Generally, our partnership agreements will mandate a reduction and/or return of capital contributions in the event that the amount of credit actually realized is less than projected levels, which shortfall would in all likelihood arise from a failure of the general partner to adhere to the rent and income rules... We also have other remedies in our possession.... We have interests to protect... and we do not hesitate to enforce our rights when necessary....[94]

Because of their self-interest credit syndicators engage in monitoring of projects they have syndicated to ascertain project compliance with credit requirements. Syndicators conduct annual due diligence reviews of project general partners' performance and require annual audited financial statements. Boston Financial also has "a team of asset managers dedicated solely to the monitoring of the projects in which [it] participate[s]. They monitor quarterly financial information, tenant qualifying procedures, property operations and also make site visits to ensure that the property is being well-maintained."[95] The Enterprise Social Investment Corporation, a subsidiary of The Enterprise Foundation that is a principal sponsor of non-profit projects, often "performs as a special limited partner with on-going monitoring responsibilities and duties."[96] "To ensure compliance with low-income occupancy requirements, ESIC performs an annual on-site review of tenant income verification files."[97]

Notwithstanding the self-interest of project developers and syndicators in program compliance and their existing private systems of compliance monitoring, there is strong support among various parties for the credit agencies' assumption of a larger role in monitoring project compliance with program requirements. After noting the lack of clear accountability of the credit agencies for program monitoring the General Accounting Office recommended:

> Projects that have been awarded credits should be carefully monitored to ensure that they continue to qualify for the annual credits by serving low-income families. Effective monitoring procedures, coupled with clearly defined responsibilities for compliance reviews and appropriate sanctions for non-compliance, should be established to discourage program abuses.[98]

Mr. Haynsworth supported a greater role of the credit agencies, "provided that the process is reasonable and not burdensome or overly costly to project sponsors."[99] Others, including Bart Harvey of The Enterprise Foundation, emphasize the need for sensitivity to the additional costs of an expanded monitoring role of the credit agencies.

While the credit agencies vary in their enthusiasm for assuming a larger monitoring role[100], some agencies like Florida's have already embarked upon an "active" monitoring program and perceive the assumption of an aggressive State role as essential to program compliance.[101] Mark Hendrickson, speaking on behalf of Florida, urged:

> So I would encourage you in your report and in the extension of this program to require that proactive monitoring by the allocating agency.[102]

Such an expansion of the State role would be consistent with the credit agencies' long-term interest in the realization of the objectives of the tax credit program. The Internal Revenue Service has a financial interest in program compliance during the fifteen year period that recapture of a portion of the credit is possible.[103] The credit agencies, on the other hand, have a contractual interest in developers' compliance with the low-income family occupancy and habitability requirements for a period that may extend thirty years or longer.

RECOMMENDATION:

The Congress should clarify and expand the responsibility of housing credit agencies for monitoring credit-assisted developers' compliance with the credit program's requirements. If the role of the credit agencies is expanded, their ability to delegate any of their new responsibility to public housing authorities or other public agnecies should be made clear. Credit agencies, also, should make every effort to control the costs of any expanded monitoring program.

B. Need to Clarify Role of Credit Agencies in Evaluating Credit Program Implementation Data

The tax credit program is a long-term housing subsidy program targeted to benefit a specified portion of American families. Administration of the program is a dual responsibility of the housing credit agencies and the Internal Revenue Service with the HUD Secretary having a very limited role in making certain discrete determinations, such as the identification of "difficult development areas", where the credit is subject to adjustment.[104]

The Internal Revenue Service is primarily concerned with the benefit of the tax credit to taxpayers. It is concerned with obtaining reasonable assurance that investors in credit projects receive no more tax reduction benefit than they are entitled to under the credit. It is also concerned with obtaining reasonable assurance that the appropriate portion of the credit benefit is denied in the event of non-compliance by a project developer with the credit's requirements. But, the principal objective of the Service in administering the credit program is to protect the financial interests of the United States Treasury.

The housing credit agencies, on the other hand, are primarily concerned with the housing production results of the credit program. The 1989 amendments that more specifically state the procedures for allocation of each State's credit authority are designed to enhance the achievement of this result by requiring the credit agencies to maximize the housing production benefit that may be realized from the credit.

The tax credit currently does not establish a single agency of government that is accountable for the success or failure of the credit program in achieving its Congressional objectives. As one result, there is no agency that is responsible for annually monitoring the implementation of the credit and evaluating program implementation against program purposes and objectives. HUD on its own initiative has undertaken a study with the benefit of consultants "to assess the effectiveness of the housing credit and to evaluate its role in national housing policy."[105] This study is due to be completed this year. While HUD may elect to undertake a similar study in the future, neither it, the IRS, nor any other agency has a continuing responsibility to monitor and evaluate the credit program.

It would be consistent with the immediately prior recommendation regarding the expansion of the program compliance monitoring role of the credit agencies for the agencies to evaluate annually data regarding program implementation. The credit agencies would prudently undertake such an evaluation in the interest of maintaining or attaining a well-managed credit allocation program. As with an expanded monitoring program the credit agencies will need to perform their self-evaluation efficiently based upon data known to the agencies in order not to burden administration of the tax credit program with additional costs that are passed on to the project sponsors.

RECOMMENDATION:

The Congress should clarify the responsibility of housing credit agencies for evaluating annually data regarding the implementation of the tax credit program. The Congress should require the credit agencies to report the results of their evaluations to the Congress through the Secretary of the Treasury. The Secretary should be a conduit only and not impose evaluation requirements upon the credit agencies.

HUD's study of the tax credit program will provide data and evaluation that will be useful to Congressional oversight of the credit program. It should be carefully reviewed in connection with Congressional consideration this year of extension of the program.

RECOMMENDATION:

Upon its completion of its multiyear study of the tax credit program, the Department of Housing and Urban Development should submit its study report to the Banking and tax writing committees of the Congress.

C. Need for Evaluation of Credit Agencies' Success In Allocating Credits to Projects in Tight Housing Markets and Projects that Serve FamiliesThat Are Waiting to Occupy Public Housing Units

During 1987-1988 tax credits and Section 8 Moderate Rehabilitation rent subsidies were combined to finance the rehabilitation of housing units in certain "soft" market areas of the United States. The result frequently was the delivery of housing at a cost that far exceeded the cost that would have been required using Section 8 tenant-based subsidies.[106] The 1989 amendments to the tax credit do not expressly target credit allocations to "tight" housing markets. They do provide a procedure for reallocation among credit agencies of credit authority that may not be fully utilized by some States.[107] More significantly, they accord a priority in the allocation of credits to projects that serve "the lowest income tenants"[108], and require credit agencies to apply selection criteria that include "housing needs characteristics" and "tenant populations with special housing needs."[109] They also require that the project selection criteria take account of "public housing waiting lists."[110]

These mandatory preferences or selection criteria direct the credit agencies to use the credit to address housing needs and to target credit assistance to projects that serve families that are well below the maximum income limits that define the eligible tenants of credit projects. As tenants of public housing generally have incomes within the range of twenty to thirty percent of area median gross income[111], additional subsidies normally are needed to enable families eligible for such housing to occupy credit projects.[112]

In connection with credit agencies' evaluation of program implementation data that is recommended above, credit agencies should evaluate their success in using the credit to address efficiently acute housing needs, including those of families that are waiting for occupancy of public housing units. Such an evaluation should include consideration of the relative efficiency of the credit program in satisfying such needs.

RECOMMENDATION:

In connection with the proposed expanded role of the housing credit agenices in the evaluation of program implementation data the credit agencies should monitor and evaluate their success in using the credit program efficiently to address acute housing needs, including those of families eligible for occupancy of public housing units.

ENDNOTES

1. Omnibus Budget Reconciliation Act of 1989, P.L. 101-239 (December 19, 1989); Department of Housing and Urban Development Reform Act of 1989, P.L. 101-235 (December 15, 1989).

2. Joint Committee on Taxation Print, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Cong; Public Law 99-514)(May 4, 1987)("Joint Tax Blue Book") at 162.

3. Dennis Fricke, Assistant Director, Housing and Community Development Issues, GAO, Hearings, Vol. II, April 27, 1990 at pp. 306-07.

4. Section 42(g)(2)(D) of Internal Revenue Code. Except where otherwise noted, references are to Section 42 prior to its 1990 amendments.

5. Section 42(g)(2)(B) of Internal Revenue Code.

6. H.Rept. 101-247, 101st Cong. 1st.Sess.(Sept. 20, 1989) at 1193 and H.Rept. 101-386, 101st Cong. 1st. Sess.(Nov. 21, 1989) at 535.

7. Joint Tax Blue Book (see endnote 1) at 153.

8. Section 42(c)(2), 42(g)(1), and 42(i)(3) of the Internal Revenue Code.

9. Section 42(i)(3)(C) and (E) of Internal Revenue Code.

10. Section 42(i)(3)(B) of Internal Revenue Code.

11. Section 42(i)(3)(B)(ii) of Internal Revenue Code.

12. Section 42(b) of Internal Revenue Code.

13. Section 42(i)(2) of Internal Revenue Code.

14. Section 42(i)(2)(D) of Internal Revenue Code.

15. Section 42(i)(4) of Internal Revenue Code.

16. Section 42(c) of Internal Revenue Code.

17. Section 42(f)(1) of Internal Revenue Code.

18. Section 42(h)(6) and 42(i) of Internal Revenue Code; H.Rept. 101-386, 101st Cong.1st. Sess.(Nov. 21, 1989) at 528.

19. Section 42(j) of Internal Revenue Code.

20. H.Rept. 101-386, 101st.Cong. 1st. Sess.(Nov. 21, 1989) at 526. Congress extended the credit one additional year pursuant to Section 11407 of the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508 (November 5, 1990).

21. Section 42(o) of Internal Revenue Code.

22. Hendrickson Prepared Statement at pp. 405-06.

23. General Accounting Office, Report to the Chairman, HUD/Mod Rehab Investigation Subcommittee, on Rental Housing:Observations on the Low-Income Housing Tax Credit Program (August 14, 1990) at 10.

24. Ols Prepared Statement at p. 277; Hendrickson Prepared Statement at p. 406.

25. John Ols, Hearings, Vol. 1, February 27, 1990 at pp. 153, 157, Hearings (full Committee), August 2, 1989, Ols at 156-157, 159-162.

26. Weicher Prepared Statement at p. 395.

27. Weicher Prepared Statement at p. 401.

28. Roberts, Hearings, Full Committee, September 29, 1989 at pp. 526-27.

29. Haynsworth Prepared Statement at p. 341; Conversation between Clement Dinsmore, Counsel, HUD/Mod Rehab Investigation Subcommittee, and F. Barton Harvey III and Mark Sissman on April 17, 1990.

30. Haynsworth Prepared Statement at p. 343; Hendrickson Prepared Statement at p. 408.

31. Ols Prepared Statement at p. 283; Haynsworth Prepared Statement at pp. 343-44.

32. These are illustrated by Section 8 rent subsidies that are allocated or tied to the project ("project-based" subsidy).

33. Haynsworth Prepared Statement at p. 340.

34. Id.

35. Haynsworth Prepared Statement at pp. 342-43.

36. Haynsworth Prepared Statement at pp. 343-44; Conversation between Clement Dinsmore and Martin Levine, Fannie Mae, on March 22, 1990, and Barry Zigas, National Low Income Housing Coalition, on March 13, 1990.

37. Hendrickson Prepared Statement at p. 408.

38. Ols Prepared Statement at p. 279; Haynsworth Prepared Statement at 346.

39. Haynsworth Prepared Statement at p. 346.

40. Ols Prepared Statement at p. 279.

41. Haynsworth Prepared Statement at p. 346.

42. Ols Prepared Statement at pp. 283, 285; William Haynsworth, Senior Vice President, Boston Financial Group, Hearings, Vol. II, April 27, 1990 at p. 304.

43. Haynsworth Prepared Statement at p. 347; Ols Prepared Statement at pp. 283, 285; Harvey Prepared Statement at p. 359.

44. Haynsworth Prepared Statement at p. 347.

45. Section 42(m)(1)(B)(ii) of Internal Revenue Code. As project developers do not negotiate with credit syndicators until after the preliminary allocation of credits, it is not feasible for housing credit agencies to take account of syndication costs as of the initial scoring of competing credit applications. Conversation between Clement Dinsmore and David Pinson, National Council of State Housing Agencies, March 8, 1990; Undated Memorandum from Mark Hendrickson, Executive Director, Florida Housing Finance Agency, submitted to Clement Dinsmore on July 11, 1990. The 1990 amendments remove the mandatory priority of Section 42(m)(1)(B)(ii) from the requirements of a qualified allocation plan and require instead the housing credit agencies consider intermediary costs as part of the credit underwriting required by Section 42(m)(2). Section 11407(b)(7) of the Omnibus Budget Reconciliation Act of 1990, P.L. 101-508 (November 5, 1990).

46. Section 42(m)(1)(B)(iii) of Internal Revenue Code.

47. Section 42(m)(1)(C) of Internal Revenue Code.

48. Section 42(m)(2) of Internal Revenue Code.

49. Section 42(m)(2)(C) of Internal Revenue Code.

50. Section 42(m)(2)(C)(ii) of Internal Revenue Code.

51. Mark Hendrickson, National Council of State Housing Agencies, Hearings, Vol. II, April 27, 1990 at p. 313.

52. Id. at pp. 314.

53. Hendrickson Prepared Statement at p. 408.

54. Hendrickson at p. 308; Haynsworth at p. 311; Conversation between Clement Dinsmore and David Pinson on March 8, 1990.

55. Hendrickson Prepared Statement at p. 407.

56. Hendrickson at p. 309.

57. Haynsworth Prepared Statement at p. 338.

58. P.L. 101-235, 101st Cong. 1st Sess.(Dec. 15, 1989)("P.L. 101-235") at Section 102(d) and (n).

59. P.L. 101-235 (see endnote 57) at Section 102(c).

60. Farmers Home Administration, Department of Agriculture, Interim Rule regarding Section 515 Rural Rental Housing Loan Policies, Procedures, and Authorizations, at Exhibit A-9 to rule, at paragraphs I.A and B, 55 F.R.29558, 29563 (July 20, 1990).

61. Id.

62. Department of Housing and Urban Development, Proposed Rule regarding Accountability in the Provision of HUD Assistance("HUD Section 102 Rule"), 55 F.R.25036, 25038 (discussion of Subpart B of rule)(June 19, 1990).

63. HUD Section 102 Rule, 55 F.R. at 25039 (discussion of Subpart C of rule).

64. Id.

65. HUD Section 102 Rule, 55 F.R. at 25041-42 (discussion of Subpart D of rule).

66. HUD Section 102 Rule, 55 F.R. at 25042 (discussion of Subpart D of rule).

67. HUD Section 102 Rule, 55 F.R. at 25043 (discussion of Subpart D of rule).

68. HUD Section 102 Rule, 55 F.R. at 25044 (discussion of Subpart D of rule).

69. HUD Section 102 Rule, 55 F.R. at 25044 (discussion of Subpart D of rule).

70. Barton Harvey III, Deputy Chairman, The Enterprise Foundation, Hearings, Vol. II, April 27, 1990 at p. 314.

71. Hendrickson at p. 315.

72. James Logue, Deputy Assistant Secretary for Multifamily Housing, HUD, Hearings, Vol. II, April 27, 1990 at p. 318.

73. Id. at p. 322.

74. Hendrickson at pp. 317-18 (emphasis added).

75. Haynsworth Prepared Statement at p. 337.

76. Id. at p. 342; Hendrickson Prepared Statement at p. 412.

77. Hendrickson Prepared Statement at p. 412; Haynsworth Prepared Statement at p. 349; Harvey at p. 327.

78. Haynsworth Prepared Statement at p. 349.

79. Hendrickson Prepared Statement at p. 412.

80. Logue at pp. 313, 326; HUD Section 102 Rule at Sections 12.30 and 12.50, 55 F.R. at 25048 and 25050, and at 55 F.R. at 25039-40 (discussion of Subpart C of rule).

81. Harvey at pp. 327-28.

82. Hendrickson Prepared Statement at pp. 412-13.

83. Conversation between Clement Dinsmore and F. Barton Harvey III and Mark Sissman on April 17, 1990.

84. Conversation between Clement Dinsmore and David Pinson on March 14, 1990.

85. Ols Prepared Statement at pp. 290-95.

86. Hendrickson Prepared Statement at p. 410; see also Hendrickson at p. 321.

87. Hendrickson Prepared Statement (see Appendix at p. 750).

88. Hendrickson at p. 321.

89. Id.

90. Id.

91. Section 42(m)(1)(B)(iv) of the Internal Revenue Code. Beginning in 1992 the housing credit agencies' qualified allocation plans must provide:

> a procedure that the agency (or an agent or other private contractor of such agency) will follow in monitoring for non-compliance with the provisions of this section....

Section 11407(b)(2) and (c) of Omnibus Budget Reconciliation Act of 1990, P.L. 101-508 (November 5, 1990). This 1990 amendment responds to the subcommittee's recommendation regarding the clarification of the credit agencies' monitoring role.

92. H.Rept. 101-386, 101st Cong. 1st Sess.(Nov. 21, 1989) at 538 (emphasis added).

93. Blattner Prepared Statement at p. 436.

94. Haynsworth Prepared Statement at p. 351.

95. Id. at pp. 350-51.

96. Harvey Prepared Statement at p. 357.

97. Id. at p. 359.

98. Ols Prepared Statement at p. 287.

99. Haynsworth Prepared Statement at p. 350.

100. McFall, Hearings, Full Committee, September 29, 1989 at pp. 536-37; Hendrickson at p. 323-24.

101. Hendrickson at p. 323.

102. Id.

103. Conversation between Clement Dinsmore and representatives of the Internal Revenue Service on March 9, 1990, and with staff of the Joint Committee on Taxation on March 19, 1990.

104. Section 42(d)(5)(C)(iii) of the Internal Revenue Code.

105. Weicher Prepared Statement at p. 401.

106. John Ols, Hearings, Vol. I, February 27, 1990 at pp. 152, 154-55; General Accounting Office, Report to the Chairman, HUD/Mod Rehab Investigation Subcommittee, on Rental Housing:Inefficiencies From Combining Moderate Rehabilitation and Tax Credit Subsidies (June 19, 1990).

107. Section 42(h)(3)(D) of Internal Revenue Code.

108. Section 42(m)(1)(B)(iii)(I) of Internal Revenue Code.

109. Section 42(m)(1)(C) of Internal Revenue Code.

110. Section 42(m)(1)(C)(vii) of Internal Revenue Code.

111. Fricke at pp. 307.

112. Hendrickson at p. 333. An analysis by the Florida Housing Finance Agency indicates that such additional subsidies are needed even to make a modest 20% of a project's units affordable to the average public housing residents. Undated Memorandum from Mark Henrickson, Executive Director, Florida Housing Finance Agency, submitted to Clement Dinsmore on July 11, 1990.

CHAPTER FIVE
HUD MANAGEMENT
SUMMARY

Increasing fraud or waste in any government agency is usually a sign of poor management controls. Thus, it was no surprise that the Committee's look into past and present management efforts at HUD revealed serious internal control problems which have been lingering at the agency for years. But the committee also found that these problems have persisted in part because top officials of the previous administration failed to identify and address these problems, even when such problems were brought to their attention.

Perhaps the most troubling example occurred in 1987, when HUD reported to the President and to Congress that the agency's financial management controls were adequate. At the same time, HUD management knew that serious problems existed with HUD's accounting systems, such as the fact that the accounting of the FHA fund did not comply with generally accepted accounting standards and the fund had been for the past 15 years deemed unauditable by the General Accounting Office.

Throughout the period between 1983 and 1988, the Inspector General monitored HUD management's efforts to identify and correct internal control problems. In addition to revealing that HUD management were conducting inadequate control reviews, the IG uncovered management problems which HUD Assistant Secretaries refused to identify. These problems included, among other things, serious control deficiencies within the HUD Co-insurance and the Section 8 Moderate Rehabilitation programs. Only through much heated debate did the Inspector General persuade HUD management to identify most of these problems in an annual report to Congress and the President regarding the state of HUD internal management controls.

Today, the new HUD management has taken its job seriously, but longstanding internal control problems still plague HUD programs. Most prominent is the poor shape of HUD's financial systems, which cause management decisions to be made on the basis of outdated or incorrect financial information. In fact, GAO has revealed that inadequate financial controls are not unique to HUD. Shockingly, that agency cannot point to any federal agency that can be considered a model of good management controls.

CHAPTER FIVE
HUD MANAGEMENT

I. The Importance of Effective Management

Over the past two years, the problems plaguing HUD during the previous administration have been revealed in great detail by high-profile Congressional committees, various audit reports and the media. What caused these ills -- the collapse of the FHA fund, political favoritism in awarding scarce funds, influence peddling of former HUD employees, and the embezzlement of funds -- continues to be the subject of much debate. Yet, one fact has always remained certain. These ills went unnoticed for extended periods of time because adequate management controls either did not exist at HUD or were not implemented properly.

HUD's internal managers hold primary responsibility for ensuring that adequate controls exist and are effectively utilized. Although the Congress, the Office of Management and Budget, the Inspector General, and the General Accounting Office all provide continuing oversight of HUD programs, it is the agency's managers who control the day-to-day administration and control of the organization and its programs. Given that proper controls help to prevent and uncover abuse and waste of federal assets and, no less important, ensure that the laudable goals of federal housing and community development programs are not impeded, management is not a task to be taken lightly.

A look into HUD's efforts to evaluate internal controls during the 1980's is quite revealing. During the administration of Secretary Pierce, this crucial responsibility was itself abused and not taken seriously by HUD's top management. HUD reported to the President and to Congress in 1987 that the agency's financial management controls were adequate when, at the same time, HUD management knew that they were subject to serious problems. The troubling story of how HUD's top managers, particularly its Assistant Secretaries, deceived themselves, the Congress and the President began with the passage of a little-known law by Congress in 1982.

II. Mandating Annual Management Reports

Former Comptroller General Elmer Staats painted a dismal picture when he discussed before a Congressional committee the "seemingly unending disclosure of fraud, waste, abuse and mismanagement" among federal agencies. Staats spoke of "a serious crisis of confidence in federal government programs and agencies," and the dire need for strong and effective control by management over federal agency operations. "Most agencies have not always given adequate priority to their internal control systems," commented Staats, "[GAO] has issued literally hundreds of reports and studies that disclose the fact that most agencies are operating systems vulnerable to physical losses and waste of federal property and money...."[1]

These bleak statements were made by Mr. Staats in 1981, almost ten years ago, prompting Congress to enact the Federal Managers' Financial Integrity Act of 1982 ("FMFIA"). FMFIA requires that HUD and most other federal agencies inform the President and Congress annually as to the state of each agency's management and accounting systems.[2]

In a "FMFIA report" sent to the President and Congress in December of each year, the agency heads must certify whether the internal controls of their agency provide reasonable assurance that, among other things, (1) revenues and expenditures are properly recorded and accounted for to provide reliable financial and statistical reports, and (2) funds and other assets are safeguarded against waste, loss, unauthorized use and misappropriation. These same agency heads also include in their annual report a separate statement as to whether their agency's accounting systems (sometimes referred to as financial management systems) follow General Accounting Office and Office of Management and Budget standards. If an agency head cannot give the above certifications, he or she must then list any material weaknesses with the agency's internal controls and accounting systems, along with any corrective actions outlined by the agency to eliminate each weakness. Continuing weaknesses, even if identified in previous reports, are also included, along with planned corrective actions.[3]

III. HUD's FMFIA Performance During the Pierce Administration: Lack of Commitment and Deception

During the administration of Secretary Pierce, HUD management's response to FMFIA was characterized by a lack of commitment, and, at times, outright deception. The poor performance of HUD's top management culminated in 1987 when agency managers deceived themselves, the President, and Congress by falsely certifying that certain serious weaknesses with HUD's financial management did not exist.

To those reading HUD's FMFIA report issued in December of 1987, everything seemed fine with the systems used by HUD to monitor the billions of dollars spent annually by that agency. Drafted by HUD managers, signed by Secretary Pierce, and sent to the President and Congress, the report explains that a review of HUD's accounting systems during the previous year revealed no material problems. The report further states that HUD's accounting of the FHA fund complied substantially with generally accepted accounting principles.[4]

Despite this clean bill of health, HUD management knew in late 1987 that a year-long review of its accounting systems, performed by two experienced accounting firms, had indeed uncovered a number of substantial problems. Before HUD finalized its 1987 FMFIA report, Watson Rice and Company, the prime contractor working with Price Waterhouse to perform the year-long review, provided its draft conclusions to HUD's Office of Finance and Accounting. The draft listed 62 "opportunities for strengthening operating efficiency and effectiveness," some of them serious and material problems with HUD's accounting systems. In fact, at least two of these problems had been identified by Price Waterhouse in earlier draft reports as violating either the GAO or OMB standards required for HUD's accounting systems.[5]

Among the identified problems:

(1) HUD's financial accounting was in fact comprised of numerous unrelated systems, which is a material violation of OMB standards. Price Waterhouse opined in a September, 1987 draft report circulated to HUD management that HUD "is not in compliance with [OMB standards] requiring that agencies have one integrated financial management system";[6]

(2) HUD's financial management system, including its accounting of the FHA fund, did not comply with GAO and generally accepted accounting principles. In another draft report dated September 20, 1987 and circulated to HUD management in December of 1987, Price Waterhouse stated that "HUD is not in full compliance with GAO accounting principles and standards." Price Waterhouse also concluded after extensive research that HUD's accounting of the FHA fund did not meet generally accepted accounting principles;[7] and

(3) HUD headquarters was not receiving and processing information from the field in a timely manner. The draft conclusions summarizing the results of the year-long review revealed that HUD management was making internal management decisions and assembling external reports using incomplete financial data. Noted as one of the ten "most significant findings," the report explains that data from HUD's field offices was not being received and processed in a timely manner at HUD headquarters in Washington. Consequently, management was using incomplete data for its internal management and external reports.[8]

Despite the revelations of the year-long review, the top manager within HUD's Office of Finance and Accounting wanted to believe that everything was fine with HUD's financial management, and was determined to conclude as much. HUD subsequently ignored the identified problems and represented to the President and to Congress that all was fine with HUD financial management.[9]

IV. The Inspector General and His Adversarial Role

Statements such as those found in HUD's 1987 FMFIA report would have occurred more often during the previous administration were it not for the efforts of the HUD Inspector General's office. OMB chose the Inspectors General to be watchdogs for their respective agency's performance pursuant to FMFIA. HUD's Inspector General has thus been active since 1983 auditing HUD management's evaluation of its internal controls and accounting systems, and determining whether the statements made in HUD's annual FMFIA report have a sound basis.[10]

In the early years of implementing FMFIA, the HUD Inspector General hoped to cooperate with HUD management to make the evaluation process an effective one. But the Inspector General's continuing audits of the process used by HUD management to identify problems for HUD's FMFIA reports found the agency involved generally in "a paper exercise which contributed little to evaluating and improving HUD's internal control and financial management systems."[11] For example, HUD managers were, without basis, issuing letters to the Assistant Secretary for Administration assuring that their programs were not suffering from material weaknesses. In one situation uncovered by the Inspector General, the Office of Planning and Community Development issued such a statement in 1984 despite receiving an internal memorandum indicating substantial weaknesses in three programs.[12]

By 1986, Paul Adams, the HUD Inspector General, had no choice but to assume an adversarial role. That year, his office prevented HUD management from inaccurately certifying that the agency's accounting systems were in compliance with applicable government standards. Adams' office reviewed a survey, the results of which HUD management intended to use as a basis for certifying that all was well with its accounting systems, and exposed troubling flaws. As drafted by HUD, the survey questionnaire was simply not a proper evaluation tool. Questions were phrased in such a way that a "yes" or "no" answer was sufficient, and negative answers did not necessarily lead to identification of serious problems. In addition, the responses to the questionnaires had actually indicated possible noncompliance of HUD's accounting systems with required standards, but HUD management had obviously chose to ignore these responses. Adams informed HUD management of his findings through a written audit report, causing management to ultimately certify in 1986 that it was unable to render an opinion on the state of its accounting systems.[13]

For HUD's 1987 FMFIA report, Adams compiled a list of 11 serious management problems within the agency. A number of HUD Assistant Secretaries refused to accept the existence of these problems, viewing them as personal criticisms of their management capabilities. When Adams issued an audit report listing the problems, which included difficulties with HUD's Co-insurance efforts and its Section 8 programs, HUD management ultimately agreed to include 9 of the 11 in its 1987 FMFIA report.[14]

But HUD management's reluctance to accept Adams' list of 11 problems was not the only thing that bothered Adams about HUD's 1987 FMFIA report.

Adams wondered how management could certify, as it did, that HUD's accounting systems were not subject to any material problems. Although his office was unable to audit the Watson, Rice/Price Waterhouse study prior to HUD management's release of its FMFIA report in December of 1987, Adams was assured by management that the results of the study supported its certification. But a subsequent audit by Adams during 1988 revealed the certification should never have been made. An audit report issued by Adams' office concludes, among other things:

> -- "HUD's December 31, 1987 reporting of 'substantial conformance' and 'no material nonconformances' with [its financial management system] was not fully supported by the results of its detailed evaluations.... Many findings from the evaluation...were not properly acknowledged and reported as substantial, if not material, nonconformances...";
>
> -- "To the extent that [Watson Rice and Company] perceived potential internal control weaknesses in the course of [its evaluations], they were reported to HUD as 'observations' in need of further evaluation. Some of these observations appeared to be potential significant weaknesses"; and
>
> -- "Our review of the required supporting documentation and reports submitted [under the Watson Rice/Price Waterhouse study] found that [the work of Watson, Rice] did not fully conform to normally prescribed professional standards for the conduct of work performed by a CPA firm. Sufficient, competent, relevant data in the form of workpapers were nonexistent or poorly organized and lacking in evidence of supervisory review."[15]

The tension between management and the Inspector General continued in late 1988, the tail end of the Pierce administration, when differences as to what should be included in HUD's 1988 FMFIA report could not be resolved at the staff level. Adams was forced to argue personally with HUD Assistant Secretaries over whether some of those same 11 problems listed in 1987 were serious enough to warrant inclusion in HUD's 1988 FMFIA report. Only after much heated debate and discussion did the HUD Assistant Secretaries eventually agree to include the weaknesses.[16]

Without pressure from the Inspector General, HUD management would not have recognized in their 1987 or 1988 annual reports that problems existed with, among other things, the agency's co-insurance program, and with Section 8 programs such as the Moderate Rehabilitation program. Management initially refused to report that HUD monitoring of co-insurance lenders was in violation of HUD regulations or that improper controls were causing excessive payments to owners of Moderate Rehabilitation projects. Frustrated by his experience in trying to persuade management to include these weaknesses in its FMFIA reports, Adams required after 1988 that any future audit report issued by his office state clearly whether problems mentioned in the report are, in the opinion of his office, serious enough to warrant inclusion in HUD's next FMFIA report.[17]

V. Failure to Effectively Correct Identified Management Problems

Of course, the job of management goes beyond merely identifying serious control problems. HUD managers must also take actions to correct problems and verify whether corrective actions are effectively eliminating poor management controls.

But to an administration which was loathe to identify problems, correcting them was likewise not a priority. According to the Inspector General, corrective actions were being placed on a tracking system, but HUD was not consistently verifying whether such actions were being taken. In 1985, the Inspector General's office reviewed a sample of six material weaknesses to see if corrective actions were being implemented. Only one of the six was being corrected according to the schedule reported in HUD's previous FMFIA issuance.[18]

Even worse, identified problems may have been reported as corrected when in fact they were not. For HUD's 1986 FMFIA report, HUD management removed six material weaknesses from its 1985 list, reporting that all corrective actions for the six weaknesses had been completed. After reviewing the decision process, the Inspector General concluded that four of the six weaknesses should not have been reported as corrected.[19]

HUD management in its first FMFIA report identified weaknesses with its control of single-family property appraisals. Despite a number of corrective actions taken by HUD, the poor controls were not corrected and HUD continued to experience difficulties with single-family loan appraisals. HUD nonetheless reported in 1986, three years later, that all problems in this area had been resolved. To its credit, HUD management eventually reinstated this weakness in its 1987 FMFIA report, but HUD today still characterizes the continuing problems with single-family appraisals as first identified in 1987.[20]

VI. Current HUD Management: Progress Yet Concerns

Secretary Kemp is attempting to restore credibility to HUD's FMFIA reporting. One major aspect of FMFIA involves evaluating the degree of integration of an agency's financial management system. Before Secretary Kemp took over the reins of the agency in 1989, HUD had been reporting that the department's financial management system was comprised of 8 components, despite being informed in 1987 by Price Waterhouse that HUD's financial management consisted of 34 primarily independent components. This number was increased to 77 independent components by Secretary Kemp after he conducted his own assessment for the agency's 1989 FMFIA report. The current administration has assailed former HUD managers for deciding "to exclude some [components] from the inventory," thus implying "a degree of accuracy which did not exist."[21]

Under the direction of Secretary Kemp, top managers have become active in identifying and correcting control problems, and Secretary Kemp has promised to hold each manager accountable for weaknesses which are not addressed properly. At least five of the 21 new material weaknesses listed in HUD's 1989 FMFIA report were uncovered by the efforts of HUD management. In contrast, only 2 of 69 weaknesses listed from 1983 through 1988 had been uncovered by HUD managers.[22]

The current HUD management has also developed a new system to track corrective actions and scheduled reviews to ensure that identified problems are addressed effectively. Each month, the Secretary and Undersecretary both review a printout containing the status of all actions and highlighting any progress or slippage. Secretary Kemp has also committed to creating program analysis summaries for each of HUD's programs. These summaries will include a list of controls and important financial data about each program, and can be used by management to gauge whether programs are being administered properly.[23]

But even with the increased efforts of the current administration, serious management problems still exist at HUD. Of the 42 known material weaknesses identified in by HUD management in 1989, 11 have been singled out by HUD as deserving priority attention.[24] They include:

(1) Inadequate Control of Section 8 Subsidy Payments

Current management and accounting systems at HUD are inadequate to properly track over $10 billion in annual Section 8 payments. No uniform process exists for reviewing and certifying the accuracy of payment vouchers and requisitions submitted by program participants, and accountability is fragmented between Housing, Public and Indian Housing, and Administration, as well as between field offices and headquarters. As a result, ineligible tenants are admitted to Section 8 programs, ineligible costs are being claimed by participants, and the potential for fraud is increased. In his latest semiannual report to Congress, the HUD Inspector General affirmed the continuing existence of this problem. According to the IG, HUD continues to lack reliable and accurate data needed to administer Section 8 programs "due to serious deficiencies in controls and procedures in the Section 8 accounting and budgeting systems and in the input and maintenance of contract and accounting information."[25]

(2) Inadequate Control of Single-Family Property Disposition

Current HUD procedures and accounting systems cannot assure receipt of all funds realized on the sale of single-family housing. The efforts of HUD in this area have been hampered by the fact that closing agents are not subject to any standard contract. The result has been significant losses to the FHA fund, and even defrauding of HUD funds as seen in the highly publicized case of Robin HUD. The HUD Inspector General's most recent reviews of HUD's property disposition activities in four major cities found that, although improvements have been made, "many weaknesses still remain" and the area is "still susceptible to fraud and abuse because of significant problems in HUD's financial records and ineffective Departmental monitoring of closing (settlement) agent activities."[26]

(3) Inadequate Management of Securities Issuers and Subservicers

GNMA needs to strengthen controls over approving issuers of Mortgage-Backed Securities, receiving and reviewing issuer financial statements, and approving commitments. GNMA has allowed issuers with marginal financial capacity to participate in the program, and some issuers have been provided excessive commitment authority. As result, GNMA has increased its exposure to future losses. The HUD Inspector General has recently reported similar problems with GNMA's awarding of contracts to subservicers, entities which assume the servicing duties of defaulted issuers.[27]

(4) Inadequate Monitoring of Grantees and Subgrantees

HUD is failing to ensure that grantees, particularly recipients of community development grants, properly monitor subgrantees. As a result, subgrantees have failed to perform contracted services and have wasted government funds.[28]

VII. Criticism of Financial Management Government-Wide

GAO and OMB both recognize that HUD's problems are not entirely the result of the poor management commitment found at HUD during the 1980's. HUD has been the victim of long-standing and serious inadequacies in its accounting systems -- inadequacies that would allow problems to escape even the best of managers. As far back as mid-1970's, HUD's FHA fund has been deemed "unauditable" by GAO, due to the poor quality of available financial information. The most recently completed audit of the FHA fund by outside contractors estimated losses of $4.2 billion, or almost five times greater than estimated by HUD's internal financial accounting systems.[29]

The financial management systems of other federal agencies are likewise victimized by similar inadequacies. GAO audits of other agencies have exposed serious difficulties with financial systems government-wide. Last year, that agency revealed:

> "Frequently, [the problems with agency financial systems] are so severe that information needed to manage agency operations, as well as prepare agency financial statements, is unreliable and seriously deficient. Generally, these problems are more serious and deep-seated than either we or agency managers realized before our audits." [30]

Inadequate financial management is not the only type of management problem experienced by federal agencies. Federal agencies such as HUD are plagued with other types of inadequate management controls that inhibit the implementation and policy goals of key federal programs. FMFIA reports have revealed numerous weaknesses in key agency program management functions such as procurement, personnel and organizational management, and determining eligibility for entitlement. In its most recent report on the status of FMFIA, GAO stated that "[d]espite the reported correction of 1,800 material weaknesses [government-wide], the condition of controls throughout the government remains poor. Agencies do not currently have the internal controls necessary to effectively manage their programs and safeguard their assets.... There is a seemingly never-ending and costly trail of mismanagement, abuse, and illegal acts involving federal programs."[31]

Assistant Comptroller General Richard Fogel of GAO has opined that "major breakdowns in management controls will continue to plague us until we give sustained attention to ensuring that the agencies have the (1) necessary mission planning systems to provide organizational direction; (2) modern and accurate financial and management information systems to monitor operations; (3) effective evaluation efforts to assess the efficiency and effectiveness of programs; and (4) dynamic human resources programs which not only recruit and develop the talented workers who are the key to any effective organization, but also have good mechanisms for holding managers accountable for results." For its part, GAO has selected 14 areas government-wide for special review, claiming that all are highly vulnerable to poor financial controls that, if left unnoticed or unattended, could cost taxpayers billions of dollars down the road. Some have been the subject of much publicity, yet others sit relatively unknown within the federal bureaucracy. They include:

(1) Resolution Trust Corporation - RTC is responsible for the management and disposal of approximately $200 to $300 billion of thrift assets. A sale of this magnitude is unparalleled in history. Without proper management and accounting, the billions of dollars changing hands will be highly susceptible to fraud and waste.

(2) Internal Revenue Receivables - IRS receivables have been estimated in excess of $60 billion, a growth of about 300 percent since 1980. Inadequate management and accounting controls could result in the loss of billions of potential revenue dollars.

(3) Medicare Questionable Claims - Medicare program dollars range in the tens of billions. Identified mispayments of $527 million by Medicare in 1985 illustrate the huge financial consequences of inadequate accounting and management controls in this area.

(4) ERISA/Pension Benefit Guarantee Corporation - The quality of the Department of Labor's and IRS' financial and management controls over ERISA has a direct financial effect on the potential losses of the Pension Benefit Guarantee Corporation ("PBGC"), an organization that has been unauditable in the past. Twenty percent of the pension plans insured by PBGC are estimated to be underfunded by a total of $20 to $30 billion. These plans relate to businesses concentrated in particular industries, and a downturn in such industries could mean large dollar losses for the federal government.[32]

OMB has also developed what it terms a "high-risk list" of problem areas within the federal government, and both GAO and OMB intend to monitor the efforts of agencies to remedy identified problem areas. But GAO and OMB can only do so much for agencies. GAO, for instance, is an agency which audits only a sample of federal programs each year. It has only rarely conducted extensive agency-wide reviews of overall agency management. Ironically, HUD was in 1983 the subject of GAO's first intensive management study of a federal agency. Indeed, the mammoth report which resulted for that study vaguely identified some serious problems: information management deficiencies ("management systems weaknesses prevent HUD from generating timely and reliable financial management data, and lines of authority are not always clear"), unclear organizational structure ("some confusion exists at all levels concerning authority, responsibilities, and functions"), lack of a defined mission ("while the [HUD's] priorities have been articulated through operating plans, they are not clearly linked to Secretarial goals and objectives"), staffing problems ("HUD lacks an 'institutional memory' -- that is, the continuity provided senior executives who understand the causes of HUD's longstanding management problems"), and poor planning ("HUD program managers and program recipients do not systematically consider long-range planning"). However, follow up was limited due to the general nature of the report's comments, and GAO has not yet performed another such review on HUD due, among other things, to the great strain that such a review places on GAO staff resources.[33]

It is primarily the job of agency management to identify problem areas, map out corrective strategies, and ensure that inadequacies are being adequately addressed. Unfortunately, financial management weaknesses needing long-term attention sometimes evade the ever-changing top management of agencies. As noted by GAO:

> "[When agency financial problems are identified,] subsequent audits of the same agencies show improvements, but also show that systems cannot be fixed overnight. Many times, it takes 2 or 3 years to cure some of these situations."[34]

VIII. Conclusion and Recommendations: The Crucial Need For Long-Term Management Attention

GAO is currently unable to point to any federal agency representing a model of efficiency for other agencies. It is a testament to the poor state of management controls throughout the federal government, and a reminder that even after seven years of FMFIA evaluation and reporting, the problems of no federal agency are yet under check.[35]

Many of the management control problems suffered by HUD and other federal agencies will require long-term attention before they can be contained. GAO, OMB and even the HUD Inspector General agree that where attention at HUD and other federal agencies is most needed, and where such attention has been most deficient, is in effectively correcting identified problems. "A lot of the focus [has been] placed on having a process in place to have some type of rationale for putting [the Secretary's] name on the bottom [of the FMFIA report]," comments one GAO official active in monitoring agency responses to FMFIA since its enactment over seven years ago. "The focus should have been on 'let's correct what's wrong.'"[36]

More than half of the weaknesses listed in HUD's 1989 FMFIA report were first identified by the previous administration, and have undergone at least one year of corrective treatment without adequate success. In fact, three of these material problems, one of which is the poor accounting of Section 8 payments discussed earlier, have continued at HUD since FMFIA reports were first mandated in 1983. Thus, they have been subject to numerous unsuccessful corrective actions -- and have survived the turnover of numerous top-level managers. Management evaluations and corrective strategies should be overseen by an individual knowledgeable about the agency: someone who will outlast numerous political elections and transcend political short-sightedness.[37]

The recent creation of a career Chief Financial Officer position at HUD will infuse the agency with a much-needed long-term perspective, at least in the area of financial management. But the responsibility of management controls under FMFIA still rests with HUD's Assistant Secretary for Administration, a political appointee. Indeed, all the top managers of HUD programs -- the Assistant Secretaries -- are subject to a political appointment process which sometimes places patronage before competence. High turnover in such positions also impedes effective management progress. During the Pierce

Administration, for instance, nine individuals assumed the crucial position of Assistant Secretary for Housing, either in an acting or Senate-confirmed role.[38]

Former HUD officials have recognized the need for a top-level management team that is responsive to Presidential policies, but they have also expressed concern that the temporary nature of political appointments may be adversely affecting HUD management. Being mindful of the need for political loyalty at the top levels of HUD, it does not seem unreasonable to insist that the Assistant Secretary for Administration, the only Assistant Secretary responsible exclusively for day-to-day administration at HUD, be an official who has experience within the Department and who is not subject to the political turnstyle. Eight other HUD Assistant Secretaries[39] who oversee specific programs and the Department's legislative and public affairs would continue to be political appointees, not to mention the numerous political appointees at the Deputy Assistant Secretary and lower levels.[40]

The committee therefore recommends the following:

RECOMMENDATION:

The Assistant Secretary for Administration at HUD should be made a career position, and should be given the responsibility for identifying and correcting material weaknesses pursuant to FMFIA.

The disagreements between the HUD IG and HUD managers during the Pierce administration, if revealed clearly at the time to Congress, would have been a manifestation of problems at HUD and a certain prompting for Congress to carefully scrutinize HUD management. Such infights must never again remain unnoticed. The opinions of each IG as to his agency's FMFIA performance must be available to Congressional committees in an easily comprehensible form.

Also, agency auditors such as the IG's and GAO should be required to make clear opinions in printed audit reports as to whether they believe problems they have uncovered by audit are material weaknesses pursuant to FMFIA. Auditors, and not agency managers, have been successful in identifying most of the material weaknesses reported in previous FMFIA reports. Requiring such auditors to identify weaknesses in audit reports will force management to consider in a more timely fashion whether to include audit-uncovered problems in FMFIA reports. It will also provide an easy way to determine exactly how many material weaknesses actually reported by agency management are the product of management evaluations or another source. The committee therefore makes the following recommendation:

RECOMMENDATION:

All IG and GAO audits of any federal agency should state in the summary whether problems discussed by the audit are considered, in the opinion of the auditor, "material weaknesses" pursuant to FMFIA.

The Subcommittee also believes that any disagreements between an IG and agency management relative to what will or will not be included in FMFIA reports should be put in writing. The writing should be sent to the relevant congressional committee responsible for conducting that agency's FMFIA hearing and should also be included within the IG's annual audit of the FMFIA process. In addition, all such audits identifying material weaknesses should be sent to the relevant congressional committees with a cover letter stating as such.

IG's should be required to investigate, and report on their findings within 30 days, allegations that agency managers may have misrepresented or lied either in their evaluations of programs for FMFIA reporting purposes or in the FMFIA report itself. This requirement was included within the original FMFIA bill proposed by the House in 1982, but it was for unexplained reasons omitted from the final law. In addition, agency managers should know that FMFIA evaluations are to be taken seriously, and false or misleading statements affecting the FMFIA process will be criminally punished.[41] The committee therefore makes the following recommendation:

RECOMMENDATION:

All inspectors general should be required to investigate any meaningful allegations that agency managers may have lied or made misrepresentations in their FMFIA evaluations or in the subsequent final report. All inspectors general should be required to report on their findings within 60 days after a formal allegation is made to them in writing.

Beginning with their September budget (1992) submissions to OMB, agencies for the first time, through revisions to Section 41 of OMB Circular A-11, will be required to estimate resources needed to address problems included on OMB's "high-risk list." OMB envisions that this submission will be an extra page added to the budget submission, detailing each high-risk area and estimating a dollar amount for each area. OMB also intends to follow-up on agency progress in correcting problems listed on OMB's "high-risk list."[42]

Although a step in the right direction, the actions by OMB are not comprehensive enough. The current OMB requirement extends only to the approximately 100 problems included in OMB's high-risk list. In contrast, the

1989 FMFIA reports of the various agency listed a total of 343 material weaknesses. Agencies should be required by statute to estimate resources that are needed to evaluate and correct all weaknesses reported pursuant to FMFIA, not simply those weaknesses determined by OMB to be high priority. In addition, OMB should follow-up to verify whether agencies are in fact making effective progress in correcting all weaknesses reported pursuant to FMFIA. The committee therefore makes the following recommendation:

RECOMMENDATION:

All agencies should be required to estimate in their annual budgets the resources needed to evaluate programs and correct weaknesses. In addition, OMB should monitor agency corrective actions to determine whether such actions are effectively addressing the problems. OMB's budget should reflect the management-side resources needed to perform such verification.

FMFIA reports are good indicators of where agencies are experiencing their most serious problems, whether it be in financial management or in program areas. Congressional committees responsible for oversight of HUD and other agencies should know where these agencies are failing. An annual hearing on the FMFIA reports of any agencies under its jurisdiction will allow Congressional committees to better understand these agencies and possibly offer constructive criticism and a little prodding. The committee therefore makes the following recommendation:

RECOMMENDATION:

The relevant congressional committees should be required to hold a hearing each year on the FMFIA report corresponding to the agency under its jurisdiction.

It remains to be seen whether the current administration can provide the proper attention needed to eliminate HUD's woes in program administration and other areas. If such attention is not provided, the next administration may inherit an agency with problems that are unmanageable.

ENDNOTES

1. U.S. Congress, House, Committee on Government Operations, "Federal Managers' Financial Integrity Act", 97th Cong., 1st sess., May 14, 1981, H.Rept. 97-38, at pp. 11-12.

2. Financial Managers' Financial Integrity Act of 1982, P.L. 97-255 (96 Stat. 814), Sept. 8, 1982 (hereinafter referred to as "FMFIA").

3. FMFIA at Sections 2, 4.

4. HUD, Federal Managers' Financial Integrity Act Report, December 1987, at Enclosure D; Transmittal Letter, Samuel Pierce, Secretary, to President Ronald Reagan, December 31, 1987.

5. Watson Rice and Company/Price Waterhouse, "Review Of The Financial Management System For Compliance With OMB Circular A-127 Objectives, Final Report," January 31, 1988 (provided in draft to HUD in December, 1987), Executive Summary at p. 3 and Exhibit ES-1; See notes 6 and 7 for cites to Price Waterhouse reports detailing serious nonconformances with HUD accounting systems.

6. Price Waterhouse, "Overall System Integration, Entitywide Report Number Five Of The HUD A-127 Review Project", September 30, 1987, Executive Summary at p. 1.

7. Price Waterhouse, "Review Of HUD's General Ledger, Entitywide Report Number Four Of The HUD A-127 Review Project", September 30, 1987; Routing and Transmittal Slip, Bob Martin, Acting Director, MIAS, HUD, to Alan Lombard, HUD, December 21, 1987; Watson Rice and Co./Price Waterhouse, "U.S. Department of Housing and Urban Development: Review of the Financial Management System For Compliance With OMB Circular A-127 Objectives, Final Report", January 31, 1988, Executive Summary at p. 23 and Exhibit ES-1.

8. Watson Rice and Co./Price Waterhouse, "U.S. Department of Housing and Urban Development: Review of the Financial Management System For Compliance With OMB Circular A-127 Objectives, Final Report", January 31, 1988, Executive Summary at P. 15 and Exhibit ES-1.

9. Janice Combs, Director, Financial Management Systems, Office of Finance and Accounting, HUD, Testimony, Hearings, Vol. 1, April 18, 1990, at p. 660-61; HUD, Federal Managers' Financial Integrity Act Report, December 1987, at Enclosure 4.

10. OMB Circular A-123, "Subject: Internal Control Systems", August 16, 1983, at paragraph 6; President's Council on Integrity and Efficiency, "PCIE Guide For Federal Managers' Financial Integrity Act - Section 2", November 1987, at p. 2.

11. Paul Adams, Inspector General, HUD, Testimony, Hearings, Vol. 1, April 18, 1990, at p. 614.

12. "Report on Review of HUD's Implementation of OMB No. Circular A-123 and the Federal Managers' Financial Integrity Act of 1982 as of September 30, 1984", Office of the Inspector General, HUD, 85-AO-169-0002, November 1984, at p. 18; Adams at p. 614, 632.

13. Adams at p. 615; "Information -- The Fourth Annual Statement Under the Federal Managers' Financial Integrity Act of 1982, OMB Circular No. A-123 Revised and OMB Circular No. A-127", Office of the Inspector General, HUD, 87-AO-161-0001, December 12, 1986, at p. 7; Transmittal Memorandum, Steven A. Sweitzer, Assistant Inspector General for Audit, HUD, to Judith Hofmann, Assistant Secretary for Administration, HUD, December 12, 1986.

14. Adams at pp. 610, 614-15, 631-32.

15. "Report On HUD's Implementation Of The Federal Managers' Financial Integrity Act Of 1982", Office of the Inspector General, HUD, 89-AO-169-0004, January 1989, at pp. 4-6.

16. Adams at pp. 610, 614-15, 631-32.

17. Adams at p. 610; HUD, Federal Managers' Financial Integrity Act Report, December 1987, at p.6 and Enclosure C; HUD, Federal Managers' Financial Integrity Act Report, December 1988, at p.16, 18 and Enclosure C.

18. "HUD's Implementation of OMB Circular No. A-123 Revised; OMB Circular No. A-127; and the Federal Managers' Financial Integrity Act of 1982", Office of the Inspector General, HUD, 86-AO-169-0001, November 19, 1985, at p. 6 and Appendix 1 -- p.3; William Deifenderfer III, Deputy Director, OMB, Testimony, Hearings, Vol. 2, April 23, 1990, at p. 135; Adams at p. 614.

19. "Information -- The Fourth Annual Statement Under the Federal Managers' Financial Integrity Act of 1982, OMB Circular No. A-123 Revised and OMB Circular No. A-127", Office of the Inspector General, HUD, 87-AO-161-0001, December 12, 1986, at p. 3.

20. HUD, Federal Managers' Financial Integrity Act Report, December 1983, at Enclosure C -- #5; HUD, Federal Managers' Financial Integrity Act Report, December 1986, at Enclosure C; HUD, Federal Managers' Financial Integrity Act Report, December 1987, Enclosure C, at p. 2; HUD, Federal Managers' Financial Integrity Act Report, December 1989, Enclosure 3 -- Material Weakness #87-2.

21. HUD, Federal Managers' Financial Integrity Act Report, December 1989, at Enclosure 4 -- p. 2.

22. HUD management claims that 11 of the 21 new weaknesses were identified by management. The Inspector General has opined that only five were identified without prior substantial audit work by the his office. Alfred A. Dellibovi, Undersecretary, HUD, Testimony, Hearings, Vol. 1, April 18, 1990, at pp. 640, 642, 644-45; "OIG Analysis of HUD's Material Weakness Identification", prepared by the Office of the Inspector General, HUD, for the HUD/Mod Rehab Investigation Subcommittee, June 1990.

23. Dellibovi at pp. 640, 644, 646.

24. Transmittal Letter, (Federal Managers' Financial Integrity Act Report), Jack Kemp, Secretary, to President George Bush, December 29, 1989, at Exhibit 1; See also List, Top Ten Material Weaknesses, provided by HUD to the HUD/Mod Rehab Investigation Subcommittee, April 23, 1990; "Inspector General's Report to the Congress", Office of the Inspector General, HUD, No. 23, March 31, 1990, at p. 5 ["Inadequate **internal controls** throughout the Department remained the leading problem at the close of the reporting period, and it cut across all programs."].

25. HUD, Federal Managers' Financial Integrity Act Report, December 1989, at Enclosure 3 -- Material Weakness #83-1; List, Top Ten Material Weaknesses, provided by HUD to the HUD/Mod Rehab Investigation Subcommittee, April 23, 1990 at No. 2; "Inspector General's Report To Congress," Office of the Inspector General, HUD, No. 23, March 31, 1990, at pp. 26-27.

26. HUD, 1989 FMFIA Report, Enclosure 3 -- Material Weakness #87-3; HUD List, HUD Material Weakness #10; HUD IG, "Inspector General's Report to the Congress," No. 23, March 31, 1990, p.14.

27. HUD, Federal Managers' Financial Integrity Act Report, December 1989, at Enclosure 3, Material Weakness #89-8; "Inspector General's Report to the Congress", Office of the Inspector General, HUD, No. 23, March 31, 1990, at pp. 45-46.

28. HUD, Federal Managers' Financial Integrity Act Report, December 1989, at Enclosure 3 -- Material Weakness #89-3; List, Top Ten Material Weaknesses, provided by HUD to the HUD/Mod Rehab Investigation Subcommittee, April 23, 1990, at No. 8.

29. Donald Chapin, Assistant Comptroller, Accounting and Financial Management Division, GAO, Testimony, Hearings, Vol. 1, April 18, 1990, at p. 704; Jeffrey Steinhoff, Director, Financial Management Issues and Audits, GAO, Testimony, Hearings, Vol. 1, April 18, 1990, at p. 704; U.S. Congress, Senate, Committee on Governmental Affairs, "Hearings on Serious Management Problems in the U.S. Government", 101st Cong., 1st sess., S. Hrg. 101-474, at pp. 282-95; See also "Financial Management Issues", GAO, GAO/OCG-89-7TR, November 1988.

30. Chapin at pp. 679-80.

31. "Financial Integrity Act: Inadequate Controls Result in Ineffective Federal Programs and Billions in Losses", GAO, GAO/AFMD-90-10, November 1989, at pp. 3, 18; U.S. Congress, Senate, Committee on Governmental Affairs, "Hearings on Serious Management Problems in the U.S. Government", 101st Cong., 1st sess., 1989, S.Hrg. 101-474; Steinhoff at pp. 708-09; See also "Implementation of the Federal Managers Financial Integrity Act: First Year", GAO, GAO/OCG-84-3, August 24, 1984; "Financial Integrity Act: The Government Faces Serious Internal Control And Accounting Systems Problems", GAO, GAO/AFMD-86-14, December 1985; "Financial Integrity Act: Continuing Efforts Needed To Improve Internal Control and Accounting Systems", GAO, GAO/AFMD-88-10, December 1987.

32. The GAO list also includes problems faced by the Department of Defense in designing and implementing an inventory management system to reduce the costs associated with DOD's excess or unneeded inventory, valued recently at over $30 billion. GAO has also singled-out the Department of Energy as inadequately overseeing the approximately $15 billion it annually obligates to outside contractors and consultants. Chapin and Steinhoff at pp. 704-05, 709; Chapin at pp. 682-86.

33. William Diefenderfer III, Deputy Director, OMB, Hearings, Testimony, Vol. 2, April 23, 1990, at p. 137; "Increasing the Department of Housing and Urban Development's Effectiveness Through Improved Management", GAO, GAO/RCED-84-9, Vol. 1, January 10, 1984 at pp. 6, 9, 12, 13, 25, and Vol. 2; Interview, John Brandolino, Senior Counsel, HUD/Mod Rehab Investigations Subcommittee with Frank Subalusky, Assistant Director, Housing Branch, GAO, July 17, 1990.

34. Chapin at p. 680.

35. Steinhoff at pp. 708-09.

36. The initial two years of the previous administration were characterized by active reporting. During that time, 37 new material weaknesses were identified for correction. In contrast, only 4 new weaknesses were identified in HUD's 1985 FMFIA report and 6 in HUD's 1986 report. Furthermore, the Inspector General's adversarial role in the FMFIA process did not develop fully until later reporting years, specifically when the Inspector General and HUD Assistant Secretaries were forced to debate whether certain weaknesses identified by the Inspector General warranted inclusion in HUD's 1987 and 1988 FMFIA reports. HUD, Federal Managers' Financial Integrity Act Report, December 1986, at Enclosure A; Adams at p. 614; Steinhoff at pp. 706-07.

37. In addition to the poor accounting of Section 8 subsidies, the other weaknesses existing since at least 1983 include inadequacies in HUD's monitoring of rental payments received from HUD-owned multi-family projects and the problems discussed earlier in this chapter regarding HUD's monitoring of single-family appraisals. See HUD, Federal Managers' Financial Integrity Act Report, December 1989.

38. List, "Assistant Secretaries/Acting Assistant Secretaries, Office of Housing -- Since 1981", provided by HUD to the HUD/Mod Rehab Investigation Subcommittee, June 29, 1990.

39. This number includes the President of Ginnie Mae.

40. Robert Weaver, former Secretary, HUD, Testimony, Hearings, Vol. 1, January 30, 1990, at p. 13; Robert Wood, former Secretary, HUD, Testimony, Hearings, Vol. 1, January 30, 1990, at p. 14; John Rhinelander, former Undersecretary, HUD, Testimony, Hearings, Vol. 1, January 30, 1990, at p. 26; Dwight Ink, President, Institute of Public Administration, Testimony, Hearings, Vol. 2, April 20, 1990, at pp. 78-81, 92.

41. The House report accompanying the House passage of FMFIA states in its section-by-section analysis of the bill:

> "(6) that the agency's Inspector General...receive and investigate allegations of false or misleading information given in connection with the evaluation of the system of internal control or in connection with the preparation of the statement or report; that the Inspector General...report any such positive findings to the head of the agency; and that the head of the agency take appropriate disciplinary or corrective action."

However, as enacted, FMFIA does not make any reference to such a provision. U.S. Congress, House, Committee on Government Operations, "Federal Managers' Financial Integrity Act", 97th Cong., 1st sess., May 14, 1981, H.Rept. 97-38, at p. 5.

42. OMB Circular No. A-11, Draft sections 41.1, 41.2 and related Exhibits, provided by OMB to the HUD/Mod Rehab Investigation Subcommittee, June 27, 1990; William Diefenderfer III, Deputy Director, OMB, Testimony, Hearings, Vol. 2, April 23, 1990 at p. 137.

CHAPTER SIX
STAFFING CAPACITY AT HUD
SUMMARY

Several important issues concerning the capacity and quality of HUD staff emerged during this Subcommittee's investigation. Through evidence gathered at the Subcommittee's hearings as well as at House hearings and through numerous studies done by the Inspector General, the General Accounting Office, Office of Personnel Management, and HUD itself, the Subcommittee has found that:

-- Despite being charged with administering increasingly complex programs, HUD requested and suffered in the last ten years a significant loss in the number and quality of staff to administer and implement those programs.

-- HUD's increased reliance upon privatization to implement programs failed to recognize the concomitant need to increase its capability to monitor program implementation.

-- HUD continued to suffer a severe "brain drain" that began in the 1970s, losing a great number of its most seasoned and experienced staff during this same time period. Part of that loss is attributable to a change of attitude that occurred as a result of a refocusing of HUD during the 1980s.

-- The number of political appointees at HUD grew significantly from 1979 to 1989 leaving HUD with a much higher number of political appointees than most other Cabinet departments. Many of these appointees lacked sufficient knowledge or interest in housing.

The effect of these trends has been HUD's inability to carry out its responsibilities efficiently and effectively, while safeguarding government monies and assets. It has resulted in the mismanagement of programs as well as blatant fraud and abuse.

HUD's staffing levels were reduced from a high of 16,749 to 11,998--a 30 percent reduction--in five years from 1981-86. Numerous Inspector General reports, a management study of HUD by the GAO, and an internal study done by the Department itself highlighted the adverse consequences to HUD programs because of these staffing cuts. These adverse effects included enormous backlogs and delays in HUD's review of loans and appraisals, superficial and deficient monitoring in many HUD programs, and little or no training of new, inexperienced staff. All studies discussed the severe consequences of financial risk to the agency as a result of losing an adequate number of staff to perform critical in-house functions and losing staff with important housing expertise.

Effects on HUD staff and program delivery were further exacerbated by the extensive and growing number of political appointees at HUD and their lack of housing experience. Over a third of HUD's Senior Executive Service (SES) are noncareer appointees. HUD leads most other Cabinet agencies, except for State and Education, with the highest percentage of noncareer appointments. As noted by the Volcker Commission, having a large number of political appointees at top levels in an agency can cause low morale and exodus by career staff, because their career advancement is cut short and their expertise is not used in critical policy-making decision positions. Political appointees can also be disruptive to day-to-day program delivery because of the short time in which they stay in their positions--a little over 2 years or less, in HUD's case.

Based on these findings, the Subcommittee recommends that HUD should undertake a comprehensive evaluation of its current staffing level and skill base, by program area, and outline those areas where HUD finds it lacks enough staff with critical skills. The Subcommittee also recommends that HUD report to Congress its plans to improve its monitoring capability. The Subcommittee also believes that HUD must examine the high level of positions now reserved for political appointees to determine if they might be better filled by career civil servants. Specifically, the Subcommittee recommends that the Assistant Secretary for Administration, because of his or her critical role in resolving HUD's financial and management systems problems, be converted to a career position.

CHAPTER SIX
STAFFING CAPACITY AT HUD

I. Introduction

The Subcommittee's announced intention was to examine programs and their implementation to help the full committee understand those programmatic design and implementation flaws which contributed to the pervasive abuse and fraud at HUD during the 1980s. One of the key factors to this analysis involves the capacity of the agency to administer those programs free of fraud, waste and abuse. Throughout our investigations and hearings, we have heard that HUD no longer had the capacity to carry out its mission. The Subcommittee was told that HUD lacked an adequate number of staff and expertise to implement programs and, when program implementation was contracted out to the private sector, HUD lacked the number, training, and skills to monitor their performance. Coupled with political appointees who refused to heed warnings of problems and the will to properly administer unpopular programs, these capacity problems led to abuse and inhibited its detection and elimination.

Among the problems the Subcommittee explored were the impact during the 1980s of reductions in staff, reductions in staff quality, privatization, reductions in travel and training, and monitoring. The Subcommittee sought the views of persons within the department, as well as those representing interests that deal with HUD. Many were of the view that reductions in number of staff were not as important as other factors. The Subcommittee found several prophetic evaluations of HUD that concluded, however, that staff reductions would lead to significant problems.

II. Staffing Problems

A. Reductions in HUD's Staffing Levels

Since its birth, HUD was an agency with a clear mission, accepted at that time as having the responsibility to provide a decent home for every American. "Good housing and good places in which to build them..." is how the first Secretary of HUD, Robert Weaver, characterized the ultimate goals of the agency at the Subcommittee's first hearing.[1] To meet this huge challenge, HUD had staffing levels between 14,661 and 16,067 from 1970 to 1979.

With the arrival of the Reagan Administration in 1980, a new mission for the federal government was espoused--to cut the size of the federal government at large and reduce domestic spending, especially in a number of social programs, including housing.[2] As a result of this and an increased emphasis on privatization, drastic staffing cuts at HUD occurred between the years 1981-1989.[3] According to agency budget figures provided to the Subcommittee, HUD's staff was cut, overall, by 20 percent during that period. For the years 1981-1986, when full-scale cutbacks and reductions in force were being instituted, the staff was cut by as much as 30 percent from its 1979 level.[4]

The Office of Management and Budget (OMB) was very active in providing guidance and targets for staff reductions for HUD, asserting almost every year in its budget preparation letters its goal of reducing the scope and size of the government. For example, in 1984, OMB provided HUD with a breakdown of its staff-year[a] targets, by program area, for fiscal years 1982-84.[5] Two of HUD's largest programs, Single and Multi-Family Insurance programs were targeted to be cut by 27 and 43 percent, respectively, in two years. The Government National Mortgage Association (GNMA), which is responsible for overseeing billions of dollars in assets for the federal government, was targeted to be cut by 22 percent by 1984 (to 45 staff-years) even though it was only staffed at 57 staff-years in 1982.[6]

B. HUD's "Brain Drain": The Loss of Experienced Staff

As stated, most of the witnesses believed that the diminution in the quality of staff was more critical to the problems at HUD than the loss of numbers. They cited lack of training, inadequate pay to compete with the private sector, inadequate travel funds for effective monitoring, and reduced morale and changed attitudes as principal causes.

While the loss of experienced personnel at HUD began in the 1970s when FHA was merged with HUD and placed less emphasis on technical training, it was greatly exacerbated by the Reagan Administration's new philosophy about the role of the federal government in housing and its efforts to cut the budget.[7] With the ensuing staff cuts, a number of consequences occurred. Functions which the Department still wanted to deliver but could not because of limited staff, such as full mortgage insurance programs, were contracted out to the private sector. As a result, an exodus of experienced staff left HUD, reading what they thought were clear signals regarding the limited advancement available at the agency because of HUD's cutback in direct program delivery. An adjunct to this was that the private sector, which now was handling tasks once performed by HUD staff, was able to entice talented HUD staff with specialized skills to leave.[8]

Witnesses also cited the absence of sufficient training of its staff. One witness testified that this failure began in the 1970s and continued well into the 1980s. HUD failed to recognize that it needed to re-train its staff to monitor the private sector in its implementation of programs. HUD also failed to provide its staff with adequate travel budgets to monitor programs and conduct management reviews.[9]

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[a] A staff year is a unit of measure which equates to one full-time person working for a year.

C. Changes in Attitude and Morale

Many also suffered from the changed attitude at HUD regarding housing programs. This impacted the ability of HUD to retain qualified personnel. One witness, Daniel Grady, described the impact of the reductions in housing programs as follows:

> I do not want to downgrade the importance of pay, but even if you receive the highest salary in the world, if you come to work every morning and you have a feeling that you are wasting your time, you have a feeling that every time you hear a comment from your friends, from your superiors that really you are a civil servant, you do not really know what you are doing, and the work you are doing is not important and we want you to do away with it, this kind of thing, I do not care how much you pay that person, eventually they will leave.[10]

This changed attitude was also seen as impacting the ability of HUD to recruit talented personnel. Grady observed:

> You cannot attract to a department qualified personnel if they are going to be attracted just to oversee the dismantling of an institution and the dismantling of a program. Very few people want to come and just preside over a funeral.[11]

D. Program Complexity

The production and management of housing is a complicated undertaking and requires a staff with some very specialized skills. In fact, one of the factors explored by the Subcommittee was the impact of program complexity rather than staffing reductions, upon the problems at HUD. Several witnesses agreed with Senator Mack's point that Congress has failed to appreciate the complexity of programs it has imposed upon HUD and the difficulty in their administration alone, much less the avoidance of abuse and mismanagement. Walter Hipps, a mortgage banker with 25 years experience at HUD said that "Section 8 is a much more complex program than anything that was administered in the 1960's." But he also believed that "the programs are not so complicated that they can't be properly administered if you have the right kinds of people with the proper training."[12] Several witnesses agreed that the complexity of programs requires sufficient staff and training to carry out the program responsibilities.

III. Impact of Staffing Problems on Program Delivery

A. Staffing Reductions

Between 1981 and 1989, reports were issued by HUD's Inspector General (IG), the U.S. General Accounting Office (GAO), and HUD's Regional Administrators that made clear the number of problems HUD faced because of its inadequate staffing levels and the effects these levels were having on program delivery.

The IG had noted in his Semiannual reports from 1981-1989 a number of problems in various HUD programs which were, at least in part, due to staffing inadequacies. The programs and activities which were affected included those in the Single Family Insurance program, specifically regarding property disposition, loan management, and co-insurance;[13] and in the Assisted Housing area, specifically in monitoring PHA procurement and contracting transactions.[14] Additionally, the IG highlighted in his Semiannual report for the first half of fiscal year 1982 HUD's continuing and pervasive problem with a lack of monitoring of programs agency-wide, noting staffing constraints as one reason for it.[15]

The Single Family Insurance Program was an area of particular concern to the IG. In 1985, for example, his office did a nationwide review of HUD's Direct Endorsement and Co-insurance Case Processing Program. Its review showed that HUD's processing of direct endorsements and reviews of loans could not keep pace with the volume of HUD-insured loan activity, which at that time had a backlog of 70,000 cases. More seriously, HUD field offices were not adequately monitoring mortgagees to detect appraisal deficiencies. "Consequently, appraisals were unsupported, properties were overvalued and HUD's insurance risks increased [emphasis added]." The IG concluded that the underlying cause for the backlog and monitoring problems were "management's inattention to shifting staffing patterns and workloads..." Although the agency acted on some of the IG's recommendations to correct these problems, semiannual reports in 1987 and 1989 continued to report on inadequate staffing levels in this particular program area.[16]

In 1984, GAO began undertaking broad-base, systematic reviews of federal agencies starting with a comprehensive management study of HUD. That report, Increasing the Department of Housing and Urban Development's Effectiveness Through Improved Management, examined HUD's major organization functions including staffing.[17] The report criticized HUD for its staffing shortages and unbalanced workloads and stated that project oversight and monitoring had grown weaker and more superficial because of workload increases and corresponding staff decreases. For example, the report cited several area offices in the Philadelphia region which were forced to use staff for monitoring in specialties for which they were not trained because they did not have adequate numbers.[18] The report concluded with a rather ominous statement:

> The effect of various staffing inadequacies will continue to take its toll on HUD's ability to monitor its programs and grantees for fraud, waste, and mismanagement.[19]

Concern about adequate staffing numbers was not only being raised by the "government watchdogs", but also by HUD staff who had to cope with the chaos it brought on a daily basis. In 1986, HUD's Regional Administrators and Regional Housing Commissioners undertook an analysis of HUD's workload and staffing levels in the field offices. Their conclusions were the same as those of the IG and GAO: staffing shortages were compromising the quality of HUD programs and making them vulnerable to risks and abuse.

This study looked at staffing issues--levels and quality--of the major programs in the Housing, Public Housing, Indian Housing, and Community Planning and Development areas. For every program except one, the report cited the serious need for more people. In almost all the programs highlighted, it outlined the dire consequences to the Department in terms of financial risk, loss of revenue, and backlogged work.[20] For example, in its summary of the key staffing issues in the Office of Housing, the report stated:

> The result [of the recent staffing cuts] is in some cases large, concrete financial losses to the Department. In others, the foundation is laid for potential losses as great, or even greater that those already experienced...The Department's insurance underwriting is a multibillion dollar enterprise. That business is suffering under present staffing levels. Further cuts could be disastrous [emphasis added].[21]

Regarding the Single Family Property Dispositions program, the report concluded that:

> Further reductions in staff will continue to make a bad situation worse. HUD could become a parking lot for properties...Holding costs, presently at $10 a day per property, with an average holding time of 6.7 months equal a yearly total... of over $45 million per year on the national inventory. This figure would increase with further staff reductions. HUD will be forced to rely more on its contractors with even less monitoring. The risk of fraud will increase sharply [emphasis added].[22]

And in the Multifamily Housing Development area, another warning was raised:

> Any further staffing reductions would only weaken our underwriting capacity. Under these circumstances, the $40+ million loss suffered by the General Insurance Fund in 1985 will be a mere drop in the bucket [emphasis added] as compared to the losses incurred if field offices are forced to underwrite current volumes with even further reduced staff levels.[23]

Unfortunately, these warnings not heeded. Adams told the Subcommittee that he twice warned Pierce of problems with the co-insurance program, only to be rebuffed.[24] Adams also had warned Pierce of problems with the allocation of funds under the Mod Rehab program. Again his concerns were ignored. Rather than heed these warnings, Pierce chose to trust those who ran the program, such as Dean, who characterized its operation as a political machine. After all, Pierce testified, "the IG is not God."[25]

Perhaps the reason these warnings were not heeded was Pierce's opposition to the program itself. The Pierce Administration recommended the abolition of many programs, such as Mod Rehab, which was seen as inefficient and ineffective. Congress disagreed and continued funding the program, as well as other HUD programs, but at reduced levels. As the Inspector General pointed out, however, Congress did not fund staff for the program. Unfortunately, HUD did not adequately reallocate resources to the program to meet its needs.[26] Pierce agreed, testifying that:

> [W]e were being squeezed with [the Moderate Rehabilitation Program] because every year at the last minute, Congress would put the thing back and give us money for the program, but no money for staff.[27]

Faced with the management of programs it no longer wanted, HUD had the options of seeking programmatic changes or increased assistance to improve their efficiency or effectiveness or allowing them to fall into mismanagement and disarray.[28] Sadly, the latter occurred. Rather than staff troubled programs such as Mod Rehab adequately, or recognize that privatization necessitated the development of monitoring capability to replace implementation skills, HUD allowed programs to degenerate. The result was substantial loss that could have been avoided.

B. Loss of Experienced Staff

HUD is the largest insurer of home mortgages in the country through FHA. It is the only producer of public housing for people of low and moderate income means, and it provides billions of dollars a year to states and cities through loans, grants, vouchers and certificates. In order to protect these assets from misuse, abuse, and mismanagement, HUD must have staff who are not only dedicated but knowledgeable about the financing and management of housing programs. In fact, many of our witnesses attributed problems not to the loss of numbers of staff, but to the loss of skill. As we have learned through these hearings and other evidence, HUD has lost a considerable amount of its experience and skill.

Along with describing the field's problems with inadequate staffing levels, HUD's Regional Administrators' staffing analysis also underscored the loss of experienced staff and the impact on the Department's quality of work. Specially affected were the tasks of overseeing the work of third parties or temporary help, training new or less experienced staff, and the amount of time it took to perform normal, in-house functions.

Specifically highlighting the Single Family Housing Development program, the report, written in 1986, predicted problems in the underwriting area which over the last year have materialized and which have been a focus of hearings by this Subcommittee. The report states:

> The quality of work performed by fee personnel as well as the quality of HUD's review of their work are critical components of sound underwriting. The quality of both has been declining due to recent staff cuts which have made acceptable levels of HUD involvement impossible. When the quality goes down the risk to the Department in terms of rate of default increases.[29]

The report continues:

> In short, mediocrity has become the rule; and this will serve us ill as many mortgages insured during this high volume period may be found in default during the first critical 18 month period. Our increased inattention to detail has already resulted in increased client dissatisfaction with HUD staff, and an inability by staff to justify some decisions made in haste...[30]

Some HUD organization units were particularly affected by the "brain drain", especially FHA. During the Subcommittee's hearings, Brian Chappelle, representing the Mortgage Bankers Association, testified to the decimation of the FHA staff throughout the 1980s. He cited some alarming statistics from a study his organization had done at FHA in 1985:

-- 22 percent of all FHA field staff had been in their current job for less than one year.

-- 25 percent of all supervisors in the appraisal and underwriting areas had less than one year's experience.

-- 55 percent of all appraisers at FHA were 50 years or older.[31]

What Chappelle and his organization understood from these numbers was that, in an agency that is responsible for about $296 billion in mortgage insurance, a significant number of FHA staff were without experience, some being moved from other parts of the agency because of the personnel shortage.[32] In HUD's New York Office, for example, Chappelle stated that in 1986, 12 key positions had to be filled by temporary personnel.[33] It also appeared that FHA had not developed any new talent as evidenced by the significant proportion of staff who were 50 years or older.[34] A similar concern was raised in the Regional Administrators' study whereby field offices were worried that Congress, by allowing for early-out retirement, would further encourage the loss of experienced personnel.[35]

As seasoned staff left HUD, the most significant impact experienced by Chappelle's constituency was the extensive and lengthy delays in obtaining HUD approvals, input, and money for multifamily projects. Because of these processing delays which, at times, were up to two years, many multifamily projects became financially infeasible to continue pursuing. In addition, HUD staff who had little experience in mortgage finance and insurance were placed in critical jobs and could not answer questions or interpret regulations for lenders. This, too, resulted in delays but also inconsistent requirements, continually frustrating lenders attempting to do business with the Department.[36] Chappelle's recommendation to the Subcommittee was direct and to the point: increase the number and quality of full-time staff at HUD.[37]

HUD's "brain drain" did not only affect those in the mortgage and insurance industry; home builders were impacted as well. John Koelemij, former President of the National Home Builders Association, confirmed the earlier testimony of Chappelle that HUD and those groups who worked with the agency, indeed, suffered from the loss of critical personnel during the 1980s.

As with the mortgage lenders, builders and owners of single-family and multi-family properties also experienced lengthy and unnecessary delays in the implementation of HUD programs in which they took part. Koelemij pointed out that when interest rates dropped and housing activity increased, HUD could not meet the demand to help families purchase new homes or refinance existing mortgages. Similarly, it did not have the staff to handle the numerous properties put into its care as a result of defaults due to the collapse of housing markets in certain sectors of the country.[38] But the real impact, Koelemij concluded, was far more serious than the examples cited. He stated that:

> Not only did the federal government lose more than was necessary from a financial perspective but far too many families lost their right to basic shelter...[39]

IV. Political Appointees

A corollary to the issue of adequacy of staffing capacity, is the issue of political versus career staff at HUD. This is true for a number of reasons. First, political appointees have important management positions which affect the ability of career staff to perform, and the level of political appointees impacts an agency's ability to retain quality career staff, including opportunities for advancement and morale.

There was nothing unique during the 1980s in the fact that many persons were employed at HUD due to political considerations. The Office of Presidential Personnel placed a number of people at HUD during the 1980s just as it has for previous administrations. What is of interest is that many have stated that during this period, HUD became a "dumping ground" for appointees unqualified for other agencies, placed at HUD because it lacked the will or ability to resist. What is also of interest is that HUD has a high, and growing, level of political appointees, which impacts HUD's ability to retain quality career staff.

A. Quality of Political Appointees at HUD

> The most important element of course in any organization is people...I decry what I regard as a modern spoils' system which is a part of our political appointment process that we tolerate in the government, and this use of the appointing system for political appointments as a patronage arm of the winning political campaign I think is a serious mistake.[40]

Dwight Ink

Witnesses before this Subcommittee and the House Subcommittee on Employment and Housing have openly criticized the quality of the political appointees to the Department, calling HUD a "political dumping ground." They have detailed how their lack experience, housing knowledge, and most certainly commitment resulted in the flagrant abuses of power and federal money that the have been exposed by the Inspector General, the media, and the Congress in the last 18 months and for exacerbating the exodus and low morale of the career staff left at HUD.

> I never should have been hired at HUD...Samuel Pierce got loaded up on him a group of Young Turks who were very political and on a must-hire list, and we had no housing experience whatsoever [emphasis added].[41]

Dubois Gilliam, former Deputy Assistant Secretary for Program Policy Development and Evaluation at HUD and convicted of conspiracy to defraud the Government, thus described the qualifications of many political appointees sent to HUD.[42] In fact, Gilliam stated that he felt that this was one of the tragedies that occurred at HUD--the White House would always compromise on the quality of the Assistant and Deputy Assistant Secretaries sent to HUD. Gilliam felt that, in the end, this contributed to the disloyalty to Secretary Pierce and the poor management of the Department.[43] Further, while other agencies gave top-level attention to filling agency positions by having their Under Secretaries work with OPP, all OPP contact with HUD had to go through Deborah Dean, and in our interviews with OPP officials who testified before the Subcommittee, they thought that Dean indeed had her own hiring agenda.[44]

The trend of placing political appointees with limited or no experience into critical positions in the federal bureaucracy is growing, as is the concern with the phenomena. Certainly this is the view of the National Commission on the Public Service (known also for its chairman as the Volcker Commission), whose task was to gather data on the nation's bureaucracy and develop recommendations to the President on ways to revive and support the public service.[45] Elliot Richardson, who has held eight Presidential appointments stated:

> More and more political appointees are being pushed into jobs traditionally held by career officials. In addition to reducing the number of positions at the top that remain open to a civil servant, the consequence is to place minimally qualified individuals in highly important posts...[46]

As a result of its findings, the Commission recommended that:

> ...the Office of Presidential Personnel establish explicit criteria for the qualifications for people nominated for each position, and that these criteria emphasize managerial experience and substantive expertise as well as loyalty and philosophical compatibility with the President..In recruiting Presidential appointees, an appropriate balance must be struck, one in which overall managerial competence and substantive expertise are given substantial weight [emphasis added]...[47]

A few years earlier, the U.S. Merit Systems Protection Board made a similar recommendation in a study which surveyed the views of former SES members, both career and noncareer. The purpose of the study was to try to discern the reasons members of this group were leaving the federal government. A number of questions were posed to career respondents about the competency of political appointees. The responses showed that career executives whose last supervisor was a political appointee were more concerned about the competence of their immediate supervisor, the politicization of their agencies, and the ethics of higher management in their agencies than those executives whose immediate supervisor was not a political appointee.[48] Further, the career respondents held the nonpolitical skills and abilities of political executives "in extremely low regard...Fewer than a quarter of the career respondents believe that political senior executives bring valuable experience to their jobs, that they possess good leadership or managerial qualities, or that they support the merit principles."[49] In light of this data, the Board recommended to OPM and agency heads that they make certain that the qualification standards established by OPM for all SES political positions be met by those appointees selected.[50]

B. Growth in the Number of Political Appointees at HUD[b]

The problem with placing political appointees with limited or no expertise in the area for which they will be making policy is compounded by the fact that their numbers are growing. For example, the total number of Presidential appointments (which require Senate confirmation) grew from 152 in 1965 to 525 in 1985, not including ambassadorial appointments, U.S. attorneys, and U.S. marshals. More seriously, the total number of noncareer Senior Executive Service (SES) positions (political appointees which are not nominated by the President nor require Senate confirmation) grew 13 percent in just six years--582 in 1980 to 658 in 1986. At the same time, career SES positions declined by 5 percent. In addition, mid-management Schedule C appointment (those at the GS 13- GS 15 range), alone, in 1986 were 946, greater than the total of all Schedule C appointments made in 1976.[51]

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[b] Definitions of Political Appointees:

The Senior Executive Service (SES) members are those who hold top-level management positions in the federal government (i.e. Secretaries, Assistant Secretaries, and Deputy Assistant Secretaries.)

Career SES appointees are career civil servants who have been appointed to an SES position by their Department through a competitive process.

Noncareer SES appointees are usually people from outside of government who have been appointed, noncompetitively, by the President or the Office of Presidential Personnel to an SES position in a Department.

PAS members of SES are those individuals who are Presidentially Appointed and Senate Confirmed to their position. An example of a PAS SES position would be that of an Assistant Secretary.

Schedule C appointees are individuals who usually come from outside of government and are appointed, noncompetitively, to mid-management positions (i.e GS 13-15) in a Department.

Similar trends have occurred at HUD over the past 10 years. Based on data provided by the Office of Personnel Management to the Subcommittee, the percentage of HUD's noncareer SES members (including PAS appointees) to its total number of career SES members grew from 19.4 percent in 1979 to a high of 35 percent in 1984. From 1984 through 1988, the number continued between 32-34 percent. The growth of political appointees in GS-15 positions at HUD has also occurred. GS-15 slots are positions just below the SES level and are considered the top of the mid-management level in the government. Again based on OPM data for the years 1979-1990, the percentage of political appointees holding GS-15 positions grew from about 6 percent in 1979 to a high of 9.5 percent in March 1988.[52]

With over a third of its top management positions going to noncareer appointments, clearly political appointees were making in-roads at HUD. And, as an agency, HUD had a significantly higher number of political SES appointments government-wide. In comparison to other Cabinet agencies for the last ten years, HUD ranked third in the percentage of its SES members who were political appointees.[53]

PERCENTAGE OF SES POLITICAL APPOINTEES IN CABINET AGENCIES: 12/31/79 - 9/30/89

State	25.9
Education	25.2
HUD	23.9[c]
Justice	16.9
Interior	14.7
Agriculture	11.8
Transportation	11.7
Commerce	11.6
Sec. of Defense	11.2
HHS	9.3
Labor	8.8
Energy	5.6
Treasury	4.0
VA	3.4

In short, more and more slices of HUD's SES "pie" (and its GS-15 "pie" as well) have gone to noncareer staff as opposed to career civil servants.

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[c] These figures exclude PAS appointments. When PAS numbers are included for HUD, its percentage would be an average of 30.3 percent for the last 10 years.

It is expected, and appropriate, that the political party which won the last election would want to place people of their party and those loyal to the President's agenda in important positions in the federal bureaucracy in order to effectively implement his new policies. However, when political appointees take more and more positions previously reserved for career staff, the effect on morale of the civil servants and ultimately on program delivery is adversely affected.

As the Volcker Commission pointed out, when political appointees fill career slots, especially those at higher levels such as deputy secretary positions, the long-term prospects of career civil servants are cut short. They can no longer aspire to critical policy-making positions where his or her experience and knowledge can be used to its fullest extent. As a result, good people are discouraged from entering or staying in public service.[54]

Others point out that the benefits derived by increasing the numbers of political appointees in the government--i.e. getting the President's program carried out--is overrated. Appointees at lower levels can have divided loyalties in that they are also supported by members of Congress and interest groups for the positions to which they are appointed. Some have commented that because of this civil servants are actually more responsive to carrying out policy and program directions than appointees.[55] The result of this, as the Volcker Commission study concluded, is that:

> ...the increasing number of political appointees has decreased the influence of the senior career staff at the same time that less qualified political executives are turning over so quickly that they cannot master their jobs. 'The result is to weaken their ability to carry out the Administration's mandate and, often, to wreak havoc in the day-to-day administration of agency programs.'[56]

For example, Walter Sevier, former Deputy Regional Administrator for HUD's Fort Worth Office testified to the fact that a $7 million UDAG grant being sponsored by Leonard Briscoe, a business partner to Lance Wilson who was an Executive Assistant to Secretary Pierce, was funded over the unanimous objections of Sevier's technical staff.[57]

Sevier told a similar tale concerning the co-insurance of a project, Colonial House, by DRG Funding Corporation which is now under investigation by the Justice Department for fraud and misrepresentation. Basically, DRG, in its underwriting of the Colonial House project, overinflated the mortgage by over $50 million dollars. Even though HUD's professional staff in both the Fort Worth and Washington offices agreed that this was an "outrageous" figure, a clear and deliberate attempt at fraud and misrepresentation, and should not be funded, the word came down from the Secretary's office to Sevier to fund the project.[58]

Shirley Wiseman, former General Deputy Assistant Secretary recounted a similar story. And while some appointees like Wiseman tried to support the recommendations and input of the career staff, in many cases it was to no avail. As a result, the DRG and Realridge projects as well as others like them have been added to HUD's ever-growing defaulted-projects portfolio.

C. High Turnover for Political Appointees

There is a disturbing trend over the past administrations toward reduced tenures for those holding political appointee positions. In addition to the problems caused by their increasing number at lower ranks in government and their minimal qualifications, the fact that political appointees don't stay very long in their job adds other problems. According to data provided by the Volcker Commission report, the average tenure of Reagan political appointees was 2 years. This is down from 2.8 years for President Johnson's Administration; 2.6 years for President Nixon; and 2.5 for President Carter.[59] In fact, the Commission's report cited more alarming figures and some interesting contrasts when the data is broken down by specific positions. The report states:

> From 1964 to 1984, the proportion of political appointees who stayed in position 1.5 years or less was 41.7 percent for cabinet secretaries, 62 percent for deputy secretaries, and 46.3 percent for under secretaries. From 1979 to 1986, noncareer members (political appointees) of the Senior Executive Service remained in office an average of 20 months. Fully 40 percent of political executives throughout the government stayed in their positions less than one year. In contrast, 70 percent of career executives have been with their agencies for 10 years and 50 percent of them for 15 years [emphasis added].[60]

The tenure of HUD's political executives fared a little better than Reagan appointees as a whole, but their tenure was still short. For those executives who were Presidentially appointed and Senate confirmed (excluding the Secretary's position), tenure averaged 2.4 years. For those executives appointed to SES positions by OPP, their tenure averaged 2.5 years.[61]

However, during the 1980s HUD suffered from a few particularly alarming instances of high turnover in critical positions. For example, the position of Assistant Secretary of Housing (which is responsible for overseeing FHA) was held by 10 different people (including Acting Secretaries) during Pierce's eight year tenure, whose average length of stay in the position was less than 8.4 months.[62] Other important positions such as the Under Secretary of the Department and the Assistant Secretary for Community Planning and Development (responsible for about $3.5 billion in assistance to cities and states) also had appointees with short tenures, averaging 16 and 20.6 months respectively.[63] This is an interesting contrast to the tenures of the former first and second HUD Secretaries, Robert Weaver and Robert Wood, where not a single Assistant Secretary left during their time as Secretaries.[64]

The problem with short tenures for top political positions is somewhat obvious. First, as with any job or position, it takes time to learn. Federal programs, housing being no exception, are complicated and encumbered by years of federal regulation and policy making. As one official put it, "Appointees on the job two years have enough time to make mistakes but often not enough time to put the resulting lessons to use."[65] Secondly, the "in-and-outer system", helps destroy the institutional memory of an agency, and with political appointees in positions in lower levels of the bureaucracy, the link between the policy makers and the implementers is severed and becomes useless for those coming after.

V. Recommendations

To run federal programs effectively, it takes adequate funding, strong management and financial systems, and, most importantly, committed and knowledgeable people. In attempting to understand how such pervasive abuse and mismanagement could occur at HUD and thereby hope to prevent similar events from reoccurring in the future, the Subcommittee has come to understand through the evidence presented at its hearings that without a enough staff with the right mix of skills, adequate funding can be misused and strong financial and management control systems can be circumvented.

The Subcommittee recognizes and applauds the efforts of Secretary Kemp to revitalize and rebuild the Department. It also agrees with the testimony presented by Under Secretary DelliBovi to the Subcommittee that it is important to assess the "outputs" of the Department as well as its "inputs", and not automatically assume that the"inputs"--including staffing levels--are the root cause of the problems. However, through testimony presented by witnesses at our hearings, reports by the Inspector General, GAO, and HUD's own Regional Administrators, as well as through data provide by OPM, the Subcommittee still feels that there are strong indications that HUD faces a serious problem with its staffing capacity and that the problem should be addressed as expeditiously as possible.

While the Department under Secretary Kemp has requested money to hire additional people, Under Secretary DelliBovi has testified before this Subcommittee that HUD has enough resources to handle its responsibilities. He stated that his concern is that there has been too much focus on "inputs", such as staffing levels, and too little emphasis on "outputs".[66] In short, the Department will not be advocating to hire more staff unless it is conclusively proven to be a root cause for the problems HUD faces.[67]

Paul Adams, Inspector General for HUD, disagreed. In testimony before the Subcommittee, Adams stated:

> It is our opinion that the HUD staff resources in terms of numbers and expertise are not currently available to deal with the myriad of problems facing the Department today. Our opinion is... based on the historical perspective that spans many years, and we attribute many of HUD's problems to critical staff shortages.[68]

Adams cited, as an example of the staffing problems HUD faces, its review of HUD's Retirement Service Center program.[69] This program, which provided both full and co-insured mortgages to facilities which catered to the elderly, is experiencing high default rates and was terminated by HUD. However, as the IG points out, the staff handling the termination of this program working with the failed lenders, is the same staff who is handling the closings of the full co-insurance program while at the same time attempting to maintain an active loan servicing workloads to avoid future defaults. Furthermore, while this program was of particular concern to the IG and his testimony specifically recommended increased staff levels for it, he also noted continuing problems in carrying out more traditional functions such as effective monitoring and program redesign in other HUD areas.[70]

As Adams stated at our hearing on staffing issues, "... past attempts at HUD to do 'more with less' have failed...enhancement of the HUD staff is imperative."[71] As the numbers on HUD staffing cuts show, HUD staff has been reduced to almost "bare bones" over the last several years. It cannot stop the current programs from hemorrhaging, let alone deal with any new ones it plans to implement without first attempting to rebuild its corp.

The "National Affordable Housing Act" (S. 566), as passed by the Senate, also addresses the capacity issues at HUD. It requires that the Secretary make certain that the Department has the capacity and resources, "including staff and training," to carry out its responsibilities. In addition, it requires the Secretary to report to Congress annually on the Department's plans for maintaining that capacity.

RECOMMENDATION:

HUD should conduct its new capacity study concurrently with its in-depth review of its housing programs.

Further, the Subcommittee recommends that HUD's report be as comprehensible as possible. For example, we believe that the Department should undertake an analysis of the skill level of its current staff by program area and outline those areas where it lacks enough staff with critical skills as well as training needs. The report should also include a long-range plan with timeframes and budgetary requirements for acquiring the skills needed. Last, there has been much discussion recently regarding the "wage gap" faced by federal employees and the impact it is having on hiring by the federal government. In light of this, HUD's report should address any compensation issues faced by the Department in recruiting and keeping the staff it needs.

The Subcommittee is also concerned about the failure of HUD to adequately monitor persons and entities with whom it contracts to perform services and implement programs. While the Subcommittee is encouraged by the concerns expressed by the current administration that monitoring be emphasized, it also indicated that enforcement was more important. Certainly HUD must enforce its programs and seek criminal and civil actions against those who defraud or abuse its programs, but that is after the fact. Effective monitoring helps ensure that enforcement actions are not needed. Among the problems in the past was inadequate numbers of staff to conduct monitoring, inadequate training in monitoring skills, and inadequate funding for travel and other expenses associated with monitoring. Accordingly, HUD should include in its capacity report to Congress its plans to improve its capability to monitor the performance of persons and entities with whom it contracts to implement programs, together with budgetary needs and training programs.

The Subcommittee is also concerned with the growing trend by the government to politicize more and more positions which were once filled by career civil servants, and it appears that HUD is no exception. The effects of this trend, as suggested by the evidence, is that day-to-day administration of programs can be disrupted, institutional memory lost, and the morale of the career staff suffers which makes recruiting and keeping them much harder. While the Subcommittee is mindful of the important role served by political appointees, the level of political appointees at HUD, and the continued growth in that level, concern the Subcommittee as it has reviewed the need for the agency to retain and recruit qualified career staff to perform complex tasks. The provision of high-level, critical positions to career staff rewards them for their technical competence and expertise, improves the policy-making of the Department and daily operation of its programs, and encourages people to join and stay with the agency.

RECOMMENDATION:

The Department of Housing and Urban Development should undertake a study of the level of political appointees at the agency and the positions filled by those appointees, especially at the Deputy Assistant Secretary level, to determine if the level is justified and report to Congress its evaluation and recommendations regarding those positions that might be better filled by career staff.

One position the Subcommittee believes to be particularly critical to a smooth-running Department is that of the Assistant Secretary for

Administration. Dwight Ink, President of the Institute of Public Administration, and Allen Dean, fellow of the National Academy of Public Administration, testified before this Subcommittee and discussed their concerns about creeping patronage into the civil servant ranks. They were particularly concerned about how this has affected the position of Assistant Secretary of Administration at HUD and at other federal agencies.[72] As Ink noted, the Assistant Secretary's position provides " a focal point for department-wide management leadership on behalf of the Secretary."[73] However, since becoming a political appointment the position has lost its continuity and effectiveness.[74] Dean concurred with this view and noted that:

> When these were career people of high ethical standards and thorough knowledge of the agencies, no Secretary, however sleepy, would be kept uninformed, because the ASA's [Assistant Secretary of Administration] as they were known, they knew everything that went on in their Department and they made certain very quickly that the Secretary or Administrator was promptly informed.[75]

The Assistant Secretary for Administration is responsible for many vital functions and management systems in the Department, especially those dealing with finance and accounting which have been and continue to be HUD's weakest areas. It will be especially important for this person to work closely with the new Chief Financial Officer (CFO), which the Department is in the process of hiring, as he or she establishes a sound financial structure for HUD. Rebuilding HUD's financial and management systems will be a very long process and needs the constant and continual attention of the highest levels of the Department.

RECOMMENDATION:

The Subcommittee recommends that the position of Assistant Secretary for Administration be converted to a permanent, career-SES position.

ENDNOTES

1. Robert Weaver, former Secretary of HUD, Testimony, Hearings, Vol. 1, Jan. 30, 1990 at p. 6.

2. Palmer, John and Isabel V. Sawhill, The Reagan Record. An Assessment of America's Changing Domestic Policies, An Urban Institute Study, Ballinger Publishing Company, 1984, at pp. 8-13;372-373.

3. Alfred Kliman, Director of the Office of Budget at HUD, told the Subcommittee that a substantial part of the reduction is attributable to the decision to privatize many functions and move from housing construction to income assistance programs. Kliman, Testimony, Hearings, April 20, 1990 at p. 22.

4. Analysis of personnel data provided to the HUD/Mod Rehab Investigations Subcommittee by HUD's Office of Personnel.

5. Letter from David Stockman, Director, OMB, to Samuel Pierce, Secretary, HUD, February 1984.

6. Id. [Subcommittee analysis of data provided in letter].

7. Daniel Grady, National Assisted Housing Management Association, Testimony, Hearings, Vol. 2, April 20, 1990 at p. 30; George O. Hipps, Jr. Vice-President, P.W. Funding Mortgage Company, Testimony, Hearings, Vol. 2, April 20, 1990 at pp. 7-8.

8. Grady at p. 30.

9. Hipps at p. 27; Grady at p. 31; John Koelemij, representing National Association of Home Builders, at p. 47; Brian Chappelle, representing Mortgage Bankers Association, at p. 54.

10. Grady at p. 65. Chappelle agreed, noting the impact on the attitude and morale of staff at HUD in 1981, when he and others were told of zero budgeting programs and being told by HUD management "that programs were there because the bureaucrats needed those programs to keep their jobs." Chappelle at p. 65.

11. Grady at p. 62.

12. Hipps at p. 17.

13. Report to the Congress, Office of the Inspector General, HUD, for the six month period April 1, 1981 to Sept. 30, 1981, No. 6, pp.3-4; Id. for six month period Oct. 1, 1985 to March 31, 1986, No. 15, p.10; Id. for six month period April 1, 1987, to Sept. 30, 1987, No 18, p.28; Id. for six month period Oct. 1, 1988 through March 31, 1989, No. 21, p.23.

14. Report to the Congress, Office of the Inspector General, HUD, for the six month period Oct. 1, 1984 to March 31, 1985, No. 13, p.23.

15. Report to the Congress, Office of the Inspector General, HUD, for the six month period Oct. 1, 1981 to March 31, 1982, No. 7, pp.12-13.

16. Report to the Congress, Office of the Inspector General, HUD, for the 6-month period Oct. 1, 1985 through March 31, 1986, No. 15, p. 10; Id., 6-month period April 1, 1987 through Sept. 30, 1987, No. 18, p. 28; Id 6-month period Oct. 1, 1988 through Mar. 31, 1989, No. 21, p. 23.

17. "Increasing the Department of Housing and Urban Development's Effectiveness Through Improved Management", GAO, RCED-84-9, Jan. 10, 1984.

18. Id. at p. 103.

19. Id. at p. 104.

20. "Analysis of Workload and Staffing," Regional Administrators - Regional Housing Commissioners, June 27, 1986, pp. 4-105.

21. Id. at p. 5.

22. Id. at p. 16.

23. Id. at p. 36.

24. The HUD Inspector General performed his first audit of the co-insurance program in October 1984 and reported inappropriate underwriting practices, such as inflated appraisals and over-estimates of income and vacancy rates, that led to over-inflated mortgages totally $36 million. HUD management disagreed with the IG's assessment of the program, noting an absence of defaults. A second audit was begun in June 1987 and in that audit report, the IG found that 13 percent of loans had defaulted. Nonetheless HUD management continued to believe that Adams was "overstating the nature and extent of the problem." Paul Adams, HUD Inspector General, Testimony, House Hearings, June 30, 1989, (Unofficial transcript) at pp 12-19.

25. Samuel Pierce, former Secretary of HUD, Testimony, House Hearings, May 25, 1989 at p. 209.

26. Office of the Inspector General, "Audit of the Section 8 Moderate rehabilitation Program," 89-TS-103-0005, April 26, 1989 at p. 15.

27. Samuel Pierce, former Secretary of HUD, Testimony, House Hearings, May 25, 1989 at p. 213.

28. Actually, some would characterize the decision of Pierce much more harshly. Chairman Tom Lantos (D. California) expressed the following view to Pierce regarding Pierce's decision to seek termination of the Mod Rehab program:

> Well, should you have gotten rid of it or should you have cleaned it up? I mean you made the decision or people in your office made the decision that if you can't terminate it, then milk it.

House Hearings, May 25, 1989 at p. 215.

29. "Analysis of Workload and Staffing," HUD's Regional Administrators - Regional Housing Commissioners, June 27, 1986, p. 6.

30. Id. at p. 36.

31. Chappelle at p.46.

32. Id.

33. Chappelle, Prepared Statement, at p. 51.

34. Chappelle at p. 64.

35. "Analysis of Workload and Staffing," HUD's Regional Administrators-Regional Housing Commissioners, June 27, 1986, p.3.

36. Chappelle, Prepared Statement, Hearings, at pp. 53-54.

37. Chappelle at p. 60.

38. Koelemij, Prepared Statement, at p. 43.

39. Koelemij at p. 43.

40. Dwight Ink, President, Institute for Public Administration, Hearings, Vol. 2, April 20, 1990 at p. 73.

41. Dubois Gilliam, former Deputy Assistant Secretary for Program Policy Development and Evaluation, HUD, House Hearings, April 30, 1990 (Unofficial transcript) at p. 123.

42. Id. at pp. 122-123.

43. Gilliam, Testimony, House Hearings, May 2, 1990, (Unofficial transcript) at p. 46.

44. Memorandum to Bob Graham, Chairman, HUD/Mod Rehab Investigation Subcommittee, from John Brandolino, Senior Staff Counsel, 5/16/90, Re: Interview with Dubois Gilliam; see also, Memorandum to Janet Mascia, GAO Investigator, from John Brandolino, Senior Staff Counsel, 7/5/90, Re: Interview with DuBois Gilliam.

45. National Commission on the Public Service, Task Force Reports: "Leadership for America: Rebuilding the Public Service," Washington, 1989, at p. 5.

46. Id. at pp. 72-73.

47. Id. at p. 180.

48. U.S. Merit Systems Protection Board. "The Senior Executive Service: Views of Former Federal Executives." A Report to the President and Congress of the United States at p. 21.

49. Id. at p. 19.

50. Id. at p. 25.

51. National Commission on the Public Service, Task Force Reports: "Leadership for America: Rebuilding the Public Service," Washington, 1989, p.170.

52. Letter, Constance Newman, Director, U.S. Office of Personnel Management, to Senator Bob Graham, Chairman, HUD/Mod Rehab Investigation Subcommittee, 7/26/90.

53. Letter, Helen White, Office of Congressional Relations, OPM, to William Leary, Staff Director, HUD/Mod Rehab Investigation Subcommittee, August 14, 1990.

54. National Commission on the Public Service, Task Force Reports: "Leadership for America: Rebuilding the Public Service," Washington, 1989 at p. 170.

55. Id. at pp. 171-72.

56. Id. at p. 172.

57. Walter Sevier, former Regional Administrator, HUD, Testimony, House Hearings, Sept. 27, 1989, (Unofficial transcript) at p. 242-43.

58. Sevier at pp. 249-51.

59. National Commission on the Public Service, Task Force Reports: "Leadership for America: Rebuilding the Public Service," Washington, 1989, p. 168.

60. Id.

61. Analysis of historical data on Executive Level Positions, provided to the Subcommittee by HUD's Office of Congressional Relations, March 1990.

62. Between January 1986 and May 1987, the Under Secretary's position was vacant. This is important to note because the Assistant Secretary for Housing and the Under Secretary were two of the three positions on the funding committee Pierce established for the Mod Rehab program. The other position was filled by Deborah Dean, who was the only person on the committee with any continuity for a time.

63. Analysis of historical data on Executive Level Positions, provided to the Subcommittee by HUD's Office of Congressional Relations, March 1990.

64. Weaver at p. 40.

65. National Commission on the Public Service, Task Force Reports: "Leadership for America: Rebuilding the Public Service," Washington, 1989, p. 168.

66. Alfred DelliBovi, Under Secretary, HUD, Testimony, Hearings, March 27, 1990 at p. 438.

67. DelliBovi, Testimony, Hearings, Vol. 2, June 29, 1990 at p. 680.

68. Paul Adams, Inspector General, HUD, Prepared Statement, ~~Hearings, Vol. 2,~~ June 29, 1990 at p. 654.

69. Report to the Congress, Office of the Inspector General, HUD, for the six month period ending March 31, 1990, No. 23, pp. 37-38.

70. Adams, Prepared Statement, Vol. 2, June 29, 1990, p. 654.

71. Adams, Testimony, Hearings, Vol. 2, April 20, 1990 at pp. 75;78.

72. Dwight Ink, President, Institute of Public Administration, Prepared Statement, Hearings, Vol. 2, April 20, 1990 at p. 92; See also, Alan Dean, National Academy of Public Administration Senior Fellow, Testimony, Hearings, Vol. 2, April 23, 1990 at p. 197.

73. Ink at p. 92.

74. Id.

75. Dean at p. 197.

CHAPTER SEVEN
EXECUTIVE OVERSIGHT
SUMMARY

While HUD managers are responsible for guiding the day to day operations of the agency, the Office of Management and Budget is responsible for overseeing and coordinating management efforts of HUD and all other federal agencies. During the administration of Secretary Pierce, OMB oversight of HUD was, in the words of the current Deputy Director, essentially "moribund." OMB examiners were blind to the scandals of HUD during that time.

Ironically, OMB's management staff during the previous administration did indeed initiate an ambitious attempt to improve certain management aspects -- such as cost controls -- generally throughout the Federal Government. This effort, referred to as Reform 88, represented the most sustained management oversight effort of that agency since its reorganization from the Bureau of the Budget to OMB in 1970. However, like all past management efforts of OMB, those efforts waned due to the overpowering demand for resources by the agency's budget staff and a lack of sustained commitment.

OMB is a highly political agency which has been unable in its history to implement sustained management strategies free from political and budget-driven biases. Former BOB and OMB officials have called for a total separation of management functions from highly politicized management functions, possibly by creating a separate Office of Management within the executive branch. While OMB currently opposes this idea -- an idea that has survived since the days of the Eisenhower Administration -- it may be the only way to ensure adequate executive oversight of HUD's and other agency's management.

CHAPTER SEVEN
EXECUTIVE OVERSIGHT

I. OMB: Recognizing the "M"[1]

The Office of Management and Budget ("OMB") is generally associated with federal budget policy. Budgeting is currently a dominant policy-making process, and OMB spends a great deal of its time preparing the budgets of each agency, following budget submissions through Congress, and overseeing the execution of the budget for the current fiscal year.

But watching the federal budget is not the only responsibility of OMB. One of OMB's least-touted functions is overseeing the management of federal agencies and programs. When President Nixon created OMB in 1970, he recognized that the budget function is only one of several important management tools available to the Executive, and that "[the President] must also have a substantially enhanced institutional staff capability in other areas of executive management -- particularly in program evaluation and coordination, improvement of Executive branch organization, information and management systems, and development of executive talent." The new OMB, Nixon envisioned, would "place much greater emphasis on the evaluation of program performance: on assessing the extent to which programs are actually achieving their intended results, and delivering the intended services to the intended recipients."[2]

Given the mismanagement and abuse of certain HUD programs during the 1980's, it is important to inquire why OMB oversight of HUD management failed to uncover or prevent it. The answer has been evident since OMB's creation in 1970. OMB's management efforts have been largely unable to compete for resources or attention with the high-priority budget process, and have therefore been minimal. Even when certain management oversight strategies have received attention and resources from OMB, their effects have been adversely influenced by the short-term budget mindset and highly politicized nature of that organization.

II. OMB Management Oversight of HUD During the Pierce Administration

By all accounts, OMB's specific oversight of HUD programs during the past decade consisted of five budget examiners developing HUD's budget, and, in their spare time, reviewing HUD programs. Not surprisingly, these examiners spent almost all their time reviewing very general aggregate program data and addressing major budget policy issues. They claim they had no knowledge that HUD projects were being improperly awarded by officials in the Pierce administration[3] -- a fact which is not surprising given that the average examiner spends only two days per year in the field reviewing how the particular programs under his or her jurisdiction are administered.[4]

When OMB received HUD-specific information in the form of Inspector General and management reports, follow-up was non-existent. In fact, OMB assigned the duty of receiving the annual FMFIA reports for almost 70 federal agencies and departments to one employee. That employee duly noted whether each agency filed its FMFIA report, but never reviewed the reports critically.[5]

Inevitably, these examiners became aware of a few program problems at HUD, including the poor shape of the FHA fund and poor underwriting of single-family loans. They related their mismanagement concerns to the agency, which responded routinely that problems were being addressed. Examiners rarely followed-up on such guarantees.[6]

III. A Revealing History of Management Oversight[7]

In hindsight, OMB today admits that it failed to adequately address problems with HUD programs prior to these problems becoming highly publicized in 1989. Management was simply not a priority for the previous administration, explains present OMB officials, and the current administration will have a different attitude.[8]

Unfortunately, this explanation is not unique to the current administration, and history has shown that no administration will be effective in overseeing agency management as long as such oversight is centered within an agency dually responsible for the budget. When President Nixon reorganized the Bureau of the Budget ("BOB") into OMB in 1970, he envisioned an increased management oversight role for that agency, prophesizing that "preparation of the budget...will no longer be its dominant, overriding concern." A mere three years later, the increasing priority of the budget led to a severe impairing of that agency's management capacity. Realizing that the budget had become top priority at OMB, President Nixon allowed his staff to restructure OMB personnel by integrating management duties with budget responsibilities. Half of the management personnel positions at OMB were eliminated and their functions transferred to the General Services Administration. The remaining management positions were relocated to the budget side and renamed "Management Associate" positions. Eventually, the Management Associate positions were consumed by the budget process and became budget examiner positions.[9]

Under President Carter, management oversight consisted primarily of reorganizing the federal bureaucracy, including OMB itself. The organization's management staff was expanded and separated from the budget-side, and its duties were redefined. Carter created the President's Reorganization Project ("PRP"), promising to streamline the federal bureaucracy. However, the interest in this reorganization effort waned at Carter's midterm and was replaced by other plans. One plan, referred to as the Zero-Based Budget initiative ("ZBB"), was announced with "considerable fanfare and expectations," yet ultimately became of little interest to the administration. The results of both PRP and ZBB fell short of expectations. ZBB, in particular, has been criticized as "just another technique designed to create an image of management leadership, not to exercise direction and control." The Carter OMB also developed a Circular entitled "Management Improvement and the Use of Evaluation in the Executive Branch," which was viewed as vague and soon became ignored with the tacit approval of OMB.[10]

President Reagan's OMB launched in 1982 what it boasted as "one of the most comprehensive and ambitious efforts to improve management and reduce costs ever undertaken by any Administration." Although not specifically tailored to HUD programs, this effort, known as Reform 88, consisted of a number of goals, such as reforming cash handling throughout the federal government and integrating the different financial management systems used by federal agencies.[11]

Despite the publicity, management continued to be overwhelmed by budget priorities, and failed to garner sufficient attention. Although representing the longest management effort in recent OMB history, certain initiatives of Reform 88 were doomed to fail due to a lack of resources. The administration's goal of integrating the different financial systems of the federal agencies lingered due to limited manpower and funds. OMB's management side lost 42 percent of its staff between 1981 and 1988. Without adequate staff, OMB relied largely on agency personnel to implement this initiative. As revealed by OMB internal documents, some agencies such as HUD did not give the initiative sufficient priority. By 1989, the final goal of integrating agency financial systems had become "so far off schedule as to be somewhat ludicrous."[12]

IV. The Political Budget Process: Adversely Affecting Management Oversight

In addition to draining resources from management efforts, the ever-increasing politicizing of the budget process has led to a corresponding politicizing of OMB that has hindered OMB's ability to implement management strategies free from political, budget-driven biases. It is a development that has occurred over time, and is not attributable to any one Presidential administration.

The old BOB has been viewed as an institution where "neutral competence" benefited the nation's decisionmaking. When Kennedy was assassinated in 1963, BOB was largely a career agency, yet it performed tremendously in responding to the immediate needs of the new President. With the possible exception of Directors being used periodically as Presidential fire-fighters on pressing political issues, BOB was rarely as an institution relied upon or perceived as a source of partisan support.[13]

But by the end of the Nixon Presidency, all perceptions of the agency's neutrality had been dispelled. President Nixon changed this by replacing career division leaders with political associate directors, now known as Program Associate Directors or PAD's. He viewed the budget staff as neither loyal to the President nor effectively oriented to political policymaking. The number of political appointees at OMB increased during the Carter administration when Budget Director Bert Lance added a new layer of two political staffers, called Executive Associate Directors, between the career staff and himself.[14]

The political nature of OMB increased during President Reagan's tenure, in part because so many of Reagan's policy initiatives were purposely intertwined with budgetary strategy. Directors such as David Stockman became policy advisors and movers for President Reagan. As one commentator stated in 1985, "Stockman and his principal subordinates were everywhere: at high-level White House policy meetings, at lower-level meetings with agency representatives, at Congressional hearings, at press conferences." Stockman also initiated what one academic calls "top-down budgeting", where basic decisions affecting the budget flow downward from the Director's negotiations with the White House and agency appointees. An example of a top-down policy was the 1984 decision to place a three-year freeze on discretionary spending programs.[15]

As OMB and the budget process have both become more politicized, managerial improvement efforts have been geared towards cost-cutting and administrative efficiency, to the near exclusion of other strategies such as increasing program effectiveness and building capacity. The effects over the past decade, at least at HUD, were devastating. HUD resources declined from $34 billion in 1981 to $14 billion in 1989. Given that the visibility and political importance of the budget process is ever-increasing, the following observation of the Congressional Research Service in 1986 will continue to hold true:

> "[s]o long as OMB's predominant motivation is to achieve 'scorable savings' in the budget process...it seems likely that the exercise of central administrative controls -- regulations, directives, and reporting requirements -- will be far more compelling than the development of managerial capacity."[16]

The budget process has a relatively short-term focus, whereas the goals of management oversight are usually long-term and may not necessarily involve cost savings. As this nation's budget deficit mounts, OMB's emphasis can be expected to focus on short-term savings and budget-cutting. Management initiatives which render long-term savings will likely be valuable, but of secondary concern. Management initiatives which render little savings may possibly be ignored.[17]

Perhaps an illustrative example of OMB's short-term budget mindset is that agency's involvement with HUD's Section 235 program during the 1980's. Under that program, HUD subsidizes the mortgage payments of certain single-family homeowners who are burdened by mortgage payments which comprise a large percentage of their incomes. When interest rates were high during the late 1970's, a large number of borrowers entered into mortgages assisted by Section 235, thus requiring HUD to support payments on mortgages with interest rates as high as 17 percent.[18]

In 1983, HUD officials decided that significant long-term savings could be achieved by refinancing a large number of Section 235 mortgages. Although the idea involved spending money to persuade homeowners to refinance, it was estimated that HUD would net millions of dollars in lower Section 235 subsidies over the terms of these mortgages. With the backing of Assistant Secretary for Housing Philip Abrams, HUD drafted its 1985 budget to include provisions for such refinancing. As with every budget, HUD first submitted its draft to OMB for approval.[19]

When the administration eventually sent HUD's 1985 budget to Congress, the proposal to refinance Section 235 mortgages was conspicuously absent. OMB had rejected HUD's refinancing proposal during its review of HUD's proposed budget. The reasons for OMB's rejection expose a short-term bias: a disregard for actions which may have adverse immediate effects but beneficial long-term effects. OMB simply did not want to spend money in the immediate years to persuade homeowners to refinance. Despite never refuting that the refinancing could eliminate millions of dollars of subsidy payments in the long-term, far surpassing any money spent on initial refinancing incentives, OMB criticized the refinancing proposal's substantial short-term budgetary impact. In addition, OMB opposed the Section 235 program and it feared that Congress would invest any recaptured funds into new Section 235 mortgage subsidies.[20]

In 1987, Paul Adams, the HUD Inspector General, revisited the refinancing idea, releasing an audit report that stated refinancing could save HUD up to $844 million in future Section 235 subsidy payments. Again, OMB opposed the idea because it involved "a large initial budget hit." OMB officials also feared once again that Congress would reinvest any savings back into the program, therefore precluding Section 235 subsidies from dying "a quiet death." Mindful of OMB's criticisms, Adams wrote to OMB Deputy Director Joe Wright informing him of a pending House bill which "the Administration could support": it provided for Section 235 refinancing while requiring that the savings not be reinvested back into the program. Unfortunately, OMB neither issued a formal position on the proposed legislation nor discussed the legislation informally with Congressional staff, contributing to the bill's languish. After HUD's problems became highly publicized in 1989, the refinancing proposal was eventually revived by Congress and enacted as part of the 1989 HUD reform legislation -- six years after HUD initially included the idea in its budget submission to OMB.[21]

V. Conclusion and Recommendations: The Need To Separate the "M" From the Highly Politicized "B"

The general consensus today is that the politicized and budget-driven OMB has not been effective in providing management oversight. Instead of providing sustained management leadership to agencies, the management improvement and oversight activities of the Executive Office have been too dependent upon the preferences of individual Presidents and Budget Directors.[22]

The OMB political employees currently layered between OMB's career staff and the Deputy Director should be returned to the career track. Since the time of Nixon's presidency, critics have charged that these political employees, known now as Program Associate Directors, possess little program knowledge, remain at OMB for too short a time to obtain program knowledge, do not trust careerists, and have eroded the decision-making role of the organization's top career staffers.[23] The committee therefore makes the following recommendation:

RECOMMENDATION:

OMB's Program Associate Director Positions should be made career positions.

Calls for a complete separation of management leadership from budget leadership are not new. Even before the creation of OMB, a Presidential task force, the Heineman Task Force on Government Organization, opined in 1966 that the budget office was ill-suited for overseeing program management. It recommended establishing an Office of Program Coordination as a new unit, separate from BOB, within the Executive Office.[24]

In the past decade, two studies have revived the idea for creating an Office of Management. In 1983, a report by the National Academy of Public Administration ("NAPA") stated that the budget process "has become so intense that it has almost totally preoccupied critical OMB leadership, draining away time, interest, and staff from the managerial initiatives." According to NAPA, the federal government's preoccupation with the budget will not decline in the foreseeable future, and thus "proposals and arguments for building up and revitalizing OMB's 'management side' seem less hopeful and less realistic." The only viable solution is to create a separate Office of Management.[25]

About the same time NAPA finished its report, the President's Private Sector Survey on Cost Control, known as the Grace Commission, concluded that the original purpose behind delegating management functions to OMB -- namely, to provide much-needed direction and coordination of Executive Branch management activities -- had not been achieved. Major deficiencies existed within the current structure of federal management, such as a lack of centralized financial management, government-wide management information, and continuity in key management positions. To allow for strong centralized management leadership, the Grace Commission recommended creating an Office of Federal Management within the Executive branch.[26]

The functions that such a new office would assume have been the subject of debate. The Grace Commission suggested that any new Office of Management should continue to perform budgetary duties. NAPA, on the other hand, feels that such a new office must assume only the management-side functions of OMB, along with certain other management duties such as program planning and design, productivity and quality control. Others favor a new office that would shoulder only the management functions of OMB and, in addition, the functions of the Office of Personnel Management ("OPM") and the General Services Administration ("GSA").[27]

Critics of the proposal to create a separate office of management believe that management duties, however defined, can never become a priority on their own. They argue that management initiatives would never have received the attention it has, however inadequate this attention may be, were it not for the influence of the budget director with the President and management's intertwining within a budget-driven organization. There also exist some misgivings about creating another bureaucratic organization to micromanage federal agencies.

But if a separate office of management provides long-term management leadership and assistance, and is not empowered to regulate and overburden agencies, the segregation of management functions from the budget process would actually help and not hinder federal management efforts. To be sure, the budget process carries a short-term focus, and it can be helpful as a vehicle to impose short-term management gains on agencies. But agencies tend to resent such impositions, and the long-term good of such impositions can be more negative than positive. "Because changes were imposed on [agencies through the budget process, the agencies] never felt a sense of ownership," says one former top OMB management official. "In fact, it was only when I established our independence from the budget process that we were able to work effectively with the Department of Defense on management initiatives."[28] Another former OMB management official relates that "the only clout I got from the budget side was on the head...it was not a mutually supportive activity."[29] Simply by intervening within an agency's budget process, OMB has been viewed as an organization weilding too much influence on intimate agency affairs.[30] If management duties are extracted and placed into an organization staffed largely or entirely by competent career professionals, and possibly with the joint participation of highly-regarded private management consultants, the new office could win an independent trust of concerned agency managers, if not the President, who realize the importance of long-term tasks such as properly structuring the administration of new programs or improving financial management government-wide.

As this report was being prepared, Congress enacted legislation suggested by OMB which creates a Deputy Director position for Management.[31] OMB believes that this move will finally allow OMB management staff to compete effectively with OMB budget staff. Outside OMB, those who opposed creating a new Deputy Director recognized the need for nothing less than a complete separation of executive management leadership from the highly politicized executive budget leadership. Previous attempts by OMB to provide management its separate niche within that organization have all failed. In fact, a separate management side has existed at OMB since the previous administration, complete with a separate Associate Director for Management. Opponents contend that changing the title "Associate Director for Management" to "Deputy Director for Management" will result in little innovation at OMB.[32]

Persisting problems deserve strong yet workable solutions. Just as the continuing management problems within the federal agencies warrant serious attention, the Executive's continuing inability to provide long-term and effective management leadership warrants a strong solution. However intertwined with existing executive oversight agencies such as OPM and GSA, the creation of an Office of Management, separate from an Office of Budget, would finally allow the Executive to begin a forward-looking and relatively unbiased process to prevent the future vulnerability of HUD and other federal agencies to fraud and mismanagement. Despite its misgivings, the Subcommittee is hopeful that the increased attention to manangemenbt at OMB by creation of the Deputy Director position will be fruitful. However, the Subcommittee nonetheless believes that further thought should be devoted to the creation of a separate Office of Management.

RECOMMENDATION:

OMB should be split into an Office of Budget and a separate Office of Management.

ENDNOTES

1. While agencies themselves spend a great deal of time monitoring financial and personnel resources, the Executive Office of the President ultimately controls key financial and personnel resources each agency will receive. Through the Office of Management and Budget, the Executive Office reviews annual agency budget submissions, which include staffing projections, and ultimately determines the final budget figures submitted by each agency to Congress. Through the Office of Presidential Personnel, the Executive Office, with the cooperation of each agency Secretary, places individuals in important agency political positions. This chapter concerns primarily the role of the Office of Management and Budget in overseeing agency management. The role of the Office of Presidential Personnel in placing political appointees at federal agencies, specifically HUD, will be discussed in the chapter entitled "Staffing."

2. Reorganization Plan No. 2 of 1970, "Message of President," transmitted to Congress on March 12, 1970, as printed after 31 U.S.C. Section 501, at p. 45.

3. It should be noted that there has been conflicting evidence as to whether a former Program Associate Director at OMB, Carol Crawford, and at least one former housing examiner, Alan Rhinesmith, may have had knowledge that HUD projects were being awarded on the basis of political connections rather than on the merits of the project proposal. Dubois Gilliam, a former Deputy Assistant Secretary at HUD, has testified before the House Employment and Housing Subcommittee, and has confirmed during an interview with our staff, that Rhinesmith contacted him in March of 1987 to inform him that HUD would be funding a $10 million U.D.A.G. application submitted by the city of Albuquerque. According to Gilliam, Rhinesmith informed him that Carol Crawford had directed Rhinesmith to call Gilliam, and that OMB had been instructed by Howard Baker, then White House chief of staff, to fund the Albuquerque project. The project was eventually funded.

In contrast, Crawford and Rhinesmith have both denied having any knowledge that HUD projects were being awarded improperly. Refuting Gilliam's testimony, Rhinesmith claims that Crawford directed him to contact HUD twice -- once to determine simply whether the Albuquerque project had been funded and another time, shortly after his first call, to inform Deborah Dean that HUD was not to announce its selection of the most recent round of U.D.A.G. projects until Dean has spoken to Crawford. Rhinesmith claims that he simply followed instructions and did not inquire as to why Crawford desired to speak with Dean before HUD announced its funding decisions. Crawford has denied OMB involvement in HUD funding decisions and has specifically stated that she and OMB examiners had no knowledge of HUD's improper funding of Moderate Rehabilitation Projects.

See Dubois Gilliam, former Deputy Assistant Secretary for Program Policy and Development, HUD, Testimony, House Hearings, Unofficial Transcript, April 30, 1990 at pp. 60-62, 64-65, 98-103; Interview, John Brandolino, Senior Counsel, HUD/Mod Rehab Investigation Subcommittee and Dubois Gilliam, former Deputy Assistant Secretary for Program Policy and Development, HUD, May 8, 1990; Carol Crawford, former Program Associate Director, Economics and Government, OMB, Hearings, Senate Banking Committee, October 31, 1989, at pp. 587-88; Carol Crawford, former

Program Associate Director, Economics and Government, OMB, House Hearings, Unofficial Transcript, February 5, 1990, at p. 69-70; Deposition of Alan Rhinesmith, June 12, 1990, Stenographic Minutes at pp. 27-38.

4. William Diefenderfer III, Deputy Director, OMB, Testimony, Hearings, Vol. 2, April 23, 1990 at pp. 134-35; Interview, John Brandolino, Senior Counsel, HUD/Mod Rehab Investigation Subcommittee and Alan Rhinesmith, Chief, Financial Institutions Branch, OMB, February 27; Interview, John Brandolino, Senior Counsel, HUD/Mod/Rehab Investigation Subcommittee and Kathy Peroff, Chief, Housing/FEMA Branch, OMB, March 2, 1990; Interview, John Brandolino, Senior Counsel, HUD/Mod Rehab Investigation Subcommittee and Kenneth Ryder, Deputy Associate Director, Housing, Treasury and Finance Division, OMB, March 21, 1990; Deposition of Alan Rhinesmith and Kenneth Ryder, June 12, 1990, Stenographic Minutes at pp. 11-38; Crawford at pp. 587-88; Crawford at pp. 69-70.

5. William Deifenderfer III, Deputy Director, OMB, Testimony, Hearings, Senate Banking Committee, October 31, 1989, at p. 558;
Crawford at p. 587. Deifenderfer at pp. 134, 142;

6. Interview, John Brandolino, Senior Counsel, HUD/Mod Rehab Investigation Subcommittee and Alan Rhinesmith, Chief, Financial Institutions Branch, OMB, February 27; Interview, John Brandolino, Senior Counsel, HUD/Mod/Rehab Investigation Subcommittee and Kathy Peroff, Chief, Housing/FEMA Branch, OMB, March 2, 1990; Interview, John Brandolino, Senior Counsel, HUD/Mod Rehab Investigation Subcommittee and Kenneth Ryder, Deputy Associate Director, Housing, Treasury and Finance Division, OMB, March 21, 1990.

7. The following historical discussions in this chapter are taken from the following: Berman, "The Office of Management and Budget and the Presidency, 1912 -1979," Princeton University Press, (1979); Chubb and Peterson, "The New Direction in American Politics", Brookings Institution (1985), featuring T. Moe, "The Politicized Presidency", at pp. 235-71; Mills and Palmer, "Federal Budget Policy in the 1980s", The Urban Institute Press (1984), featuring Heclo, "Executive Budget Making", at pp. 255-91; U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134; Fisher, "Presidential Spending Power," Princeton University Press (1975), pp. 36-58. See also Harold Seidman, former Assistant Director for Management and Organization, Bureau of the Budget, and Alan Dean, former Deputy Associate Director, OMB, Testimony, Hearings, Vol. 2, April 23, 1990 at pp. 190-92; Hugh Heclo, Professor, George Mason University, Testimony, Hearings, Vol. 2, April 23, 1990, at pp. 173-77.

8. The current administration has increased their management resources and efforts. Deifenderfer, Hearings, at p. 137, 139; Interview, John Brandolino, Senior Counsel, HUD/Mod Rehab Investigation Subcommittee and Kathy Peroff, Chief, Housing/FEMA Branch, OMB, March 2, 1990.

9. One former OMB management official during the early Nixon years, Alan Dean, has commented that this integration caused a devastation of management capacity at OMB from which the agency has never recovered. Interview, John Brandolino, Senior Counsel, HUD/Mod Rehab Investigation Subcommittee and Alan Dean, former Deputy

Associate Director, OMB, April 3, 1990; Dwight Ink, President, Institute for Public Administration (former Bureau of the Budget and OMB official), Testimony, Hearings, Vol. 2, April 23, 1990, p. 220; Reorganization Plan No. 2 of 1970, "Message of President," transmitted to Congress on March 12, 1970, as printed after 31 U.S.C. Section 501, at p. 45; Executive Order, "Transfer of Certain Functions From Office of Management and Budget to General Services Administration and Department of Commerce", No. 11717, May 9, 1973; U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, at pp. 96-105.

10. U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, p.109-120.

11. Deifenderfer, Full Committee Hearings, at p. 19; Frank Hodsoll, Executive Associate Director for Management, OMB, Testimony, Hearings, Vol. 2, April 23, 1990, at p. 153-54; Memorandum, Judith Tardy, Assistant Secretary for Administration, HUD to HUD Principal Staff, October 17, 1984; U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, at pp. 120-21.

12. Other goals of Reform 88 received inconsistent support from the administration, thus limiting the program's impact. Improvement was made in a few areas supported by the administration, such as cash administration, but failure was prominent in other areas not receiving priority or attention, such as procurement reform. "Managing The Government, Revised Approach Could Improve OMB's Effectiveness", GAO, GAO/GGD-89-65, May 1989, at p. 60; Hodsoll at p.154; Deifenderfer, Hearings, at p. 153; Memorandum, Joseph R. Wright, Jr., Deputy Director, OMB to Samuel R. Pierce, Secretary, HUD, April 17, 1985 ("I would also like to express my concern that [HUD] may not be giving Reform 88 initiatives sufficient priority..."); Memorandum, Gerald R. Riso, Associate Director for Management, OMB to Judith Hofmann, Assistant Secretary for Administration, HUD, date illegible on copy, ("After reviewing your department's [financial management plan] along with those of other departments and agencies, we are concerned that we do not have agreement on what needs to be accomplished and what our priorities are to be over the next year and a half.").

13. Just two short months after the assassination, Johnson introduced a new budget which according to his wishes cut spending by $3.5 billion, a large amount for that time period. This indicated that the sudden transition from one administration to the next occurred with surprising ease, due largely in part to the institutional competence and advice of BOB

Unfortunately, in succeeding in what it did best during the sudden change in Presidency -- relying on its institutional memory, knowledge and objectivity -- the BOB may have planted the seeds for its exploitation. President Johnson recognized that BOB was a good place for creating task forces and for studying management problems because assignments were never turned down or ignored. BOB soon became a dumping ground for Presidential problems that should have been dealt with elsewhere, and it placed a great strain on the organization. Each year, numerous task forces were established to study new legislative programs, and BOB was responsible for administrating each task force and evaluating the results. By the mid-1960's, the studies and proliferating legislative agenda for Johnson's Great Society overwhelmed BOB, which became to be viewed, not surprisingly, as an unresponsive institution. Berman, "The Office of Management and Budget and the Presidency, 1912 -1979", Princeton University Press, (1979), at pp. 70-74; Heclo, "OMB and the Presidency -- the Problem of Neutral Competence", The Public Interest, No. 38, Winter 1975, at pp. 80-98.

14. Berman, "The Office of Management and Budget and the Presidency, 1912 - 1979", Princeton University Press, (1979), at pp. 118-19, 128; Chubb and Peterson, "The New Direction in American Politics", Brookings Institution, (1985), featuring T. Moe, "The Politicized Presidency", at pp. 256-57; U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, at pp. 96-105; Dean and Seidman at p. 190.

15. Chubb and Peterson, "The New Direction in American Politics", Brookings Institution, (1985), featuring T. Moe, "The Politicized Presidency", at p. 261; Mills and Palmer, "Federal Budget Policy in the 1980s", The Urban Institute Press, (1984), featuring Heclo, "Executive Budget Making", at pp. 262-71.

16. U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, at p. XIII.

17. U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, at p. 134.

18. Memorandum, Carol Crawford, Program Associate Director, Economics and Government Division, OMB to the Deputy Director, ["Refinancing Section 235 Mortgages"], March 5, 1987; Memorandum, Paul Adams, Inspector General, HUD, to Samuel Pierce, Secretary, HUD, ["Information -- Recent Report Issued, 'Refinancing Section 235 Mortgages May Save $844 Million'"], February 25, 1987.

19. Note, Pete Bowers, HUD, to Phil Abrams, HUD, ["Refinancing Section 235 Mortgages"], March 4, 1983; Memorandum, David E. Pinsky, Assistant General Counsel, Home Mortgage Division, GHH, HUD to Alan J. Kappeler, Director, Office of Single Family Housing, HSS, HUD, ["Refinancing Section 235 Mortgages"], March 11, 1983; Note, Shirley Wiseman, HUD, to Philip Abrams, HUD, April 5, 1983; Note, Shirley Wiseman, HUD, to Philip Abrams, HUD, April 13, 1983; Letter, William M. Diefenderfer III, Deputy Director, OMB, to Senator Bob Graham, Chairman, HUD/Mod Rehab Investigation Subcommittee, May 21, 1990, at Enclosure 2.

20. Letter, William M. Diefenderfer III, Deputy Director, OMB, to Senator Bob Graham, Chairman, HUD/Mod Rehab Investigation Subcommittee, May 21, 1990, at Enclosure 2.

21 Letter, William M. Diefenderfer III, Deputy Director, OMB, to Senator Bob Graham, Chairman, HUD/Mod Rehab Investigation Subcommittee, May 21, 1990, at Enclosure 2; Memorandum, Paul Adams, Inspector General, HUD, to Samuel Pierce, Secretary, HUD, ["Information -- Recent Report Issued, 'Refinancing Section 235

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22. U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, at p. XI; National Academy of Public Administration, "Revitalizing Federal Management: Managers and Their Overburdened Systems", November 1983, at p. 7; Heclo at pp. 171-78; R. Moe, "Traditional Organizational Principles and the Managerial Presidency: From Phoenix to Ashes", 50 Public Administration Review, March/April 1990, at p. 136; Dean at pp. 185-86, 193; U.S. Congress, Senate, Committee on Governmental Affairs, "Federal Management Reorganization, Cost Control, and Loan Accounting Reform", 99th Cong., 2d sess., S. Hrg. 99-879, May 13, 1986, at p. 20.

23. Berman, "The Office of Management and Budget and the Presidency, 1912 - 1979", Princeton University Press, (1979), at pp. 118-19; Dean and Seidman, Hearings, at pp. 185-87; Mufson, "'PADs' Wise to Ways of Power'," Washington Post, April 25, 1990 at p.1.

24. U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, at p. 93.

25. The Senate has previously taken interest in such a proposal. In 1986, Senator William Roth, Jr. (R-DE), then Chairman of the Senate Governmental Affairs Committee, introduced and held hearings on a bill which would, among other things, create a separate Office of Management within the executive branch.
See U.S. Congress, Senate, Committee on Governmental Affairs, "Federal Management Reorganization, Cost Control, and Loan Accounting Reform", 99th Cong., 2d sess., S. Hrg. 99-879, May 13 and 14, 1986; National Academy of Public Administration, "Revitalizing Federal Management: Managers and Their Overburdened Systems", November 1983, at pp. 11-13.

26. President's Private Sector Survey on Cost Control (Grace Commission), "A Report to the President", January 15, 1984, at pp. III-4 - III-15, VIII-53 - VIII-55.

27. National Academy of Public Administration, "Strengthening Presidential Leadership By Establishing An Office Of Federal Management, Prepared for the 1988-89 Presidential Transition", December 1988, at p. 7; President's Private Sector Survey on Cost Control (Grace Commission), "A Report to the President," January 15, 1894 at p. VVIII-54; U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, at pp. 134-44.

28. Ink at p. 220-21.

29. Dean at p. 194.

30. For an interesting comment on OMB influence at HUD see Stehr, "Top Bureaucrats and the Distribution of Influence in Reagan's Executive Branch", Unedited Working Paper, prepared for the annual meeting of the American Political Science Association, held August 31 through September 3, 1989. This paper documents the results of a survey regarding the influence of political appointees on agency career employees. OMB's influence was judged very high at the six agencies surveyed. At HUD, only the "office director" and "subcabinet secretary" were viewed as having more influence at HUD than OMB officials. See also Brian Chappelle, Staff Vice President for Residential Finance/Government Agency Relations, Mortgage Bankers Association, Testimony, Hearings, Vol. 2, April 20, 1990, at pp. 65-66; Daniel Grady, President, The Monfric Corporation, Testimony, Hearings, Vol. 2, April 20, 1990, at p. 66.

31. H.R. 5687 establishes a Deputy Director for Management who will be responsible for the "M" in OMB and for integrating and coordinating financial management functions with other management and budget functions at OMB. The legislation also establishes an Office of Financial Management at OMB to be headed by a controller who will serve as deputy to the Deputy Director for Management. The legislation also creates a chief financial officer for the major federal agencies.

32. U.S. Congress, Senate, Committee on Governmental Affairs, "Office of Management and Budget: Evolving Roles and Future Issues", 99th Cong., 2d sess., 1986, S.Prt. 99-134, at pp. 132-34; Deifenderfer at p. 148.

CHAPTER EIGHT
CONGRESSIONAL OVERSIGHT
SUMMARY

The role of Congress in conducting oversight of any agency, including HUD, is one which is time consuming and often lacks sufficient political justification, absent some particularly newsworthy scandal. "Fire alarm" oversight, such as that conducted in response to the HUD scandals, is more prevalent than continuous or "police patrol" oversight that is designed to keep Congress informed of problems before they become significant.

Many believe that Congress failed to notice warning signals of serious problems at HUD in time to correct them before they resulted in what may become billions of dollars of loss. Noteworthy of these warnings were those reported by the Inspector General in a number of semi-annual reports and other audits of HUD programs, as well as many audits by the General Accounting Office which told of significant deficiencies at HUD that put millions of dollars at risk. Meanwhile HUD was being less than honest in fully admitting its weaknesses in its annual reports pursuant to the Federal Managers' Financial Integrity Act and less than cooperative with Congress. During most of the 1980s, Congress conducted little oversight of HUD and, toward the end of the 1980s, began to focus its attention not on oversight but upon new housing legislation. This raises a number of questions: Did Congress not fail to heed the warnings it received? Were the warnings themselves watered down and lost in audit language too difficult for a busy Congress to comprehend? Whatever the problem in the past, it seems clear that review of those reports must be made a more integral part of the oversight responsibility of the authorizing committees.

Despite the fact that Congress failed to conduct hearings on the findings of any of these reports and audits, the HUD Inspector General failed to otherwise bring these problems to the attention of Congress. Like most other inspectors general, he failed to use a mechanism created by Congress to ensure that particularly flagrant problems and abuses would be brought to the attention of the agency and Congress within seven days. Much confusion exists over the circumstances in which that mechanism is intended to apply and whether it was appropriate with respect to the HUD scandals.

The Senate also missed opportunities in the confirmation process to screen from HUD incompetent and unqualified nominees to management positions or to ascertain their interest in the mission of the agency. Improvements must be made to avoid the problems at HUD which can be attributed to the placement of HUD programs under the supervision of persons who lack either ability or concern for their proper implementation.

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> I frankly will tell you that I thought no one up here gave a darn as to what was going on. That was my impression ... Remember now, the IG works for the Executive Branch of Government; he does not work for Congress. He reports to the Congress, and I felt, we reported to the Congress."[1]
>
> Charles Dempsey

Thus did Charles Dempsey, who served as the first Inspector General at the Department of Housing and Urban Development from 1978 to 1985, express his displeasure with Congress at the Subcommittee's hearing on Congressional Oversight. Mr. Dempsey was addressing the frustration he felt, and believes the current Inspector General, Paul Adams, felt, when their warnings of problems at HUD fell, in their view, upon disinterested Congressional eyes and ears. When asked of his experience with Congressional committees regarding interest in any of his semi-annual reports or other reports, Mr. Dempsey replied "I never received as much as a phone call."[2]

The focus of this chapter is upon the role of Congress in monitoring the implementation of laws by executive agencies and, specifically, congressional oversight of HUD during the 1980s. Congress has other significant roles of course. As policy maker, Congress creates programs for agencies such as HUD, some of which are difficult to administer in the best of circumstances. But HUD is a complex agency with a history of problems. While most of the abuses at HUD during the 1980s are attributable to poor administration of programs, there were design flaws which made them susceptible to abuse. Congress cannot be expected in its creation of programs to anticipate every design or implementation flaw, or every circumstance that might flow from fraud or abuse. But Congress must try to be aware of past problems and avoid their repetition and it must state its intent as clearly as possible to guide the agency to which it entrusts program implementation.

Congress has neither the expertise nor the responsibility to manage programs, nor to micro-manage them from the Hill. Consequently, when flaws exist in the design of a program, they must be uncovered in its administration and, hopefully, corrected by the interaction of the agency and Congress. One of the chief means by which that interaction occurs is oversight.

I. Introduction

Although the Constitution does not expressly provide for Congressional oversight authority, scholars believe that the power to investigate is implied in

Congress' authority to appropriate funds and enact laws. Presumably the Congress could not use its authority if it did not, in some way, know that was going on in the Executive Branch.[3] Congressional oversight authority was first exercised as early as 1792 when the Congress explored the conduct of the government in the wars against the Indians. However, oversight did not become formalized in Congress until the Legislative Reorganization Act of 1946, when House and Senate committees were required to exercise "continuous watchfulness" over the executive agencies.[4]

While most people envision Congressional oversight as *ad hoc*, media-intensive inquiries into Executive Branch activities, the Congress has several methods to determine how well the Executive Branch is implementing Congressional intent. These include the appropriations process, the authorization process, review of audits and reports, and the confirmation process.

Congress' control over an agency's budget is a powerful oversight tool. In the absence of authorizing legislation or traditional oversight hearings, Congress can use this tool to uncover, highlight, and sometimes punish agencies for actions they have or have not taken. Congress also has the authority to create, abolish, and change executive agencies and their programs. As such, this process provides the opportunity for Congress to review and critique agency implementation of programs.[5] However, the authority to channel agency behavior during the appropriations or authorization processes by threatening budget cuts is hardly effective where, as with HUD during the 1980s, the agency is itself requesting funding authority "below those desired by some members of Congress, so the threat of further cuts [becomes] self-defeating."[6]

The principal focus of the Subcommittee in its review of Congressional oversight was upon the warnings it received in various reports of problems at HUD and the process by which the Senate reviews nominees for positions at HUD.

II. The Warnings Given: Audits, Evaluations, and Reporting Requirements

Congress cannot exercise its oversight responsibilities without adequate information. To help assist it in its review of agency implementation of congressional intent and the formulation of policy, Congress has imposed reporting requirements upon the executive branch. Most of the reports Congress has required of HUD and any other executive agency relate to programs. Reports are of three general categories:(1) policy-making (often triggered by an event or are the result of a study Congress has requested the agency to undertake to assist Congress in developing policy); (2) post-facto (reports which require the agency to provide information relating to programs or achievements of the agency); and (3) advance notification (reports which require the agency to notify the Congress before taking certain action).

The most pertinent reports to this investigation are post facto reports which are designed to give the most clear warnings of problems at the agency: Reports of the Inspector General, the annual Federal Managers Financial Integrity Act (FMFIA) report , and reports of the General Accounting Office (GAO). These reports alone are significant in number. Just with respect to HUD, Congress has received 23 semi-annual Reports of the Inspector General. The HUD Inspector General has also issued 868 audit reports of various HUD programs between 1980 and 1990. Unlike the semiannual reports, these reports are not routinely sent to the committees of jurisdiction.[7]

GAO has also prepared hundreds of audits of HUD and its programs since 1981 in response to requests from particular members or committees. All were available to Congress for its review.

A. Reports of the Inspector General

The principal warnings received by Congress that problems existed at HUD were in the semi-annual reports and audit reports of the Inspector General. For this reason, and because it was an audit report on the Section 8 Moderate Rehabilitation Program that instigated the current Congressional investigations of HUD, it is important to evaluate the warnings given before embarking upon an analysis of whether or how they were missed and how they might be noticed in the future.

In 1976, the Congress created the Inspector General Act which established Offices of the Inspector General at 12 agencies including HUD.[8] The IG offices were provided the authority and responsibility for (1) supervising audits and investigations relating to program economy, and (2) recommending policies to promote economy, efficiency, and effectiveness, and to detect and prevent waste, fraud and abuse. The Act standardized their powers, duties, and responsibilities.

The Act also requires the IGs to keep the head of the agency and the Congress "fully and currently informed about the problems and deficiencies relating to the administration of such [agency] programs."[9] Pursuant to this, the Act requires the IGs to submit semiannual reports to the head of the department and Congress. These reports are to include, among other things, a description of significant problems, recommendations for corrective actions, and information on the status of previous recommendations.

During the mid to late 1980's, the HUD Inspector General conducted a number of audits which increasingly showed a failure by HUD to account for the Section 8 Moderate Rehabilitation Program. For example, in August, 1983, the IG reported that weaknesses in the PHA's administration of the Mod Rehab program could cost HUD more than $270 million in additional housing assistance payments (HAP). In October, 1985, the IG issued a memorandum report which summarized the results of 33 audit reports issued during Fiscal Years 1984-1985. The report stated that rents were excessive in 31 audits and for 78 percent of the 5,200 units tested. Excessive HAP's would have been in the hundreds of millions of dollars if this was representative of conditions across the country.

In addition, Mod Rehab problems were reported in each of the IG's Semiannual Reports starting with the 6-month period ending March 31, 1983, through September 30, 1986, and again in reports for the periods ending September 30, 1988, March 31, 1989, and September 30, 1989.[10]

On April 26, 1989, the HUD IG published a major report on the program documenting the extent of program abuse over a five year period.[11] This report was the catalyst for a barrage of media coverage and congressional inquiries which served as the foundation of this report.

The IG's basic finding was that the Mod Rehab program was poorly managed. There was virtually no documentation or accountability for the public housing authorities (PHAs) selected by HUD headquarters to receive the funding allocations. There was little assurance that units were being allocated equitably, competitively, or to those locales with the greatest need.

The report described a fundamental shift from a competitive, regulatory process to one driven by HUD headquarters to benefit favored owners, developers, and consultants. Evidence in 69 projects under review indicated possible project-specific selections by headquarters. In 49 projects under study, the awards made by HUD closely approximated the number of units owned or controlled by specific developers.

Favored developers received information about allocations before the PHAs were notified. In 19 projects, the developers approached the PHAs claiming that if it applied for units, an award would probably be made to them.[12]

In 25 projects, the developers paid consultants -- some of them former HUD officials, -- for lobbying HUD officials on the developers' behalf. All received substantial fees, commonly ranging from $1000-1500 per unit. Consultant fees went to a number of prominent figures, many of whom had little housing knowledge.[13]

Two conflicting focuses helped contribute to waste in the Mod Rehab program, which could amount to over $413 million in excess subsidies. On the one hand, the program evolved from a small scale rehabilitation program into one geared more for substantial rehabilitation. On the other hand, the program received inadequate priority within the department so that staff was not allocated commensurate with the program's needs.

These problems became even more pronounced with the introduction to co-insured financing and low-income tax credits. Co-insurers were allowed to obligate substantial amounts of Section 8 funds without proper monitoring. Tax credits were provided to project developers even though they may not have been necessary to give developers the incentive to produce the housing.

The audit stated that the "overriding cause for the program's current conditions is a lack of commitment on management's part to provide attention to those areas needing it most."[14] In particular, the report cited obsolete program regulations and only a patchwork of unrelated and ambiguous instructions from HUD headquarters which tended to confuse the lines of authority and resulted essentially in no accountability.

B. GAO Management Review Report and Other Reports

Another valuable tool available to Congress was a report prepared by the General Accounting Office (GAO) following a comprehensive review of HUD management. The report, entitled "Increasing HUD Effectiveness Through Improved Management," was the first of a series of general management reviews of executive agencies undertaken by GAO. The GAO report found that HUD needed to improve its organizational stability, increase its emphasis on general management functions, and establish continuity in its top management.[15]

Other GAO reports available to Congress which discussed problems at HUD and its management of programs include reviews of the Community Development Block Grant Program;[16] the Urban Development Action Grant Program;[17] Multifamily Property Management and Disposition;[18] the Loan Management Set-Aside Program;[19] the Section 202 Elderly Housing Program;[20] and the Section 8 Existing Rental Assistance Certificate Program.[21] These reports and nearly 100 others were available to Congress during the 1980s, providing insights into problems at HUD and its ability to operate programs free of loss and mismanagement.

III. Unsent and Unclear Warnings

A. Seven-Day Letters: A Signal Never Sent

In addition to the semiannual reports, the Inspector General is also supposed to report immediately to the agency head any "serious or flagrant problems, abuses, or deficiencies relating to the administration of programs..."[22] In turn, the agency head is to transmit this report "within seven days" to the Congress.[23] Though frustrated by the inattention of Congress to the semiannual reports, the HUD Inspector General never issued the seven-day letter, a more immediate and visible "red flag," to alert Congress to problems.[24] This apparently is not unusual though, according to Mr. Kaiser from the Congressional Research Service, who stated that the seven-day letter had only been used eight times by any IG since the passage of the Inspector General Act.[25]

That was the finding of the Inspections and Special Reviews Committee of the President's Council on Integrity and Efficiency (PCIE) which conducted a survey of the inspectors general in 1986 to determine the extent to which they have used or contemplated the use of the seven-day letter.[26]

In addition to the eight uses of the seven-day letter, use was considered on a number of occasions. For example, the IG of the Department of Commerce seriously considered issuing a letter in 1982 regarding a dispute with the agency over the IG's budget. The IG of the Department of State decided not to bother Congress with seven-day letters on two occasions because Congress became aware of the issues involved by other means. The HUD IG responded that on several occasions the use of the letter was considered but not used when the issues were resolved by management.[27]

The issue of the use of the seven-day letter was explored as part of a series of hearings held by the Senate Committee on Government Affairs relating to serious management problems in the federal government.[28] In response to a request from Senator Carl Levin (D. Michigan) the PCIE updated its 1986 survey and found that the seven-day letter has been since used twice, both times by the Agency for International Development. The IGs at the Departments of Commerce, Defense, and Labor considered the use of the letter during this period but found the issue resolved by management.[29]

At the September 28, 1989 hearing of the Senate Committee on Government Affairs, Sherman Funk, Inspector General of the Department of State, was asked about the use of the seven-day letter as a means of getting the attention of Congress and the agency regarding serious problems. Funk had studied the use of the letter for the PCIE. He stated that the various inspectors general do not read the requirement in the law as it may have been intended, taking the view expressed by the Inspector General of the Department of Defense that the letter would only be used where the Inspector General had reported a serious problem to management and management denied or covered up the existence of the problem, thus taking no corrective action.[30]

Our Subcommittee heard different explanations. Adams and Dempsey told the Subcommittee that the reason the seven-day letter was not used was because of the lack of specific criteria defining "flagrant." Since the semiannual report is to contain a description of "significant abuses and problems" to be reported, it is difficult to distinguish between what is "significant" versus what is "flagrant." And as Dempsey stated, he felt that it was enough to report these problems in the semiannual report; he saw no point in reporting them again in a seven-day letter.[31]

Adams also told the Subcommittee that he did consider using the letter to notify Congress of his findings regarding the Moderate Rehabilitation Program, but chose not to in light of the actions taken by Secretary Kemp.[32] By then, however, it was too late; the Pierce Administration had left office.

Such confusion regarding congressional intent exists despite the effort of PCIE in 1986 to answer the question "Under what circumstances does Congress expect to receive 7-day reports from the Inspectors General"[33] In that document circulated to the various inspectors general, PCIE concluded that the seven-day letter was intended to be used in limited cases since Congress intended the semi-annual reports to be the conduit for the reporting of problems at an agency. Significantly, PCIE concluded that the letter was to be used "only in those situations so egregious as to require Congressional oversight to produce a satisfactory result."[34] According to PCIE, situations satisfying this requirement fall into the following categories:

(1) Serious and politically sensitive problems identified by an Inspector General on which an agency head refuses to act;

(2) Serious problems involving matters of law which only Congressional action can resolve;

(3) Particularly serious problems involving high level agency officials or large amounts of public funds;

(4) Other truly exceptional circumstances which, in the judgment of the Inspector General, require immediate Congressional attention.[35]

Apparently these guidelines have not helped the inspectors general discern when the use of the letter is appropriate. As noted above, in several cases the letter has been used by an IG to lobby Congress on pending legislation or to ask for additional funds. It seems that there remains confusion over whether the agency head must refuse to take any action on a problem and whether the letter applies to a new problem omitted from the semi-annual report or if it can also apply to a problem which comes up again and again in several semi-annual reports without resolution. Given the serious nature of the problems at HUD, one is left wondering why none of these guidelines applied, but as Dempsey asked the Subcommittee, after pointing out that the problems had been raised repeatedly in semi-annual reports, "how many times do we have to report significant problems?"[36]

Nor is more recent efforts by PCIE to clarify the use of these warnings likely to work. According to Kaiser, the mere substitution of a seeming synonym, "egregious," in the explanatory phrase "egregious waste, fraud, abuse, or mismanagement" could result in even fewer uses of the letter if seen as connoting a more exacting standard.[37]

Kaiser was of the view that the statute lacks sufficient clarity and could benefit from greater specificity to enable the IGs to understand the circumstances in which Congress intends to be notified of particularly serious and flagrant problems.[38] He noted, for example, that neither the statute nor the accompanying committee report defined the phrase "particularly serious or flagrant problems, abuses, or deficiencies." Rather, the House Governmental Operations Committee report only describes what it does not mean:

> It does not require that all matters reported to the agency head be automatically reported to the Congress, nor does it prescribe the amount of detail to be furnished when reports are required. It does not contemplate reporting of unsupported allegations.[39]

In addition to the issue of congressional intent, is the following concern expressed by Funk regarding Congressional reaction to the receipt of a seven-day letter:

> In a number of cases, 7-day letters have been written by IG's and they have disappeared into a void here on Capitol Hill, sir, and that does not give us much confidence. When you say, well, if I get into a bad scene, I am going to slip them a 7-day letter and then you do it and you have no hold card left, at that point you are very naked, sir, you are very naked indeed. So, you have to be careful, if you pull a gun, there damn well better be ammunition in it, and that is one problem.[40]

We cannot know whether Congress would have paid more attention to the problems at HUD earlier had it received a seven-day letter exposing the serious problems plaguing the agency. Certainly neither Adams or Dempsey appear to believe so. However, in some instances, inspectors general who have used this procedure believe that it got results.[41] Nonetheless, the concern expressed by Funk led him to suggest that in order to be assured that Congress paid attention to the letter, Congress should be required to issue a reply.[42]

B. Unclear Warnings

While the abuses which occurred at HUD have come to light because of the persistent and constant efforts of the Inspector General, as documented in his semiannual and other audit reports, some criticism surfaced regarding the effectiveness of the IG reports at sounding the warning.[43]

At a hearing of the Senate Committee on Governmental Affairs, Senator William Roth (R. Delaware) expressed concern that the HUD IG Semiannual reports gave a false sense of calm to busy Senators. He cited as examples from the Seventh Semiannual Report (for the six-month period ending March

31, 1982) the statement "but we would like to comment on the unprecedented cooperation we have received from the current management team" and from the following two reports in 1982 and 1983 that mentioned favorably the level of cooperation by management in resolving problems. Senator Roth concluded, "Frankly, just reading through these, you know, you sort of think there really is not a problem, that it is being taken care of."[44]

An example of this occurred at our hearing on Congressional Oversight. Dempsey testified that the Inspector General's Seventeenth Semiannual Report clearly laid out significant and ongoing problems in the Single Family Mortgage Insurance program. He quoted from the Executive Summary:

> Four items deserve particular attention. The first is Single Family Mortgage Insurance fraud. We have discussed this in prior reports but our work indicates it is still a significant problem across the nation.[45]

What Dempsey did not quote were the final two sentences of that same paragraph.

> ... the Department has made numerous program changes. Additional civil and administrative actions are being taken which should help remedy the situation.[46]

Other examples exist. The executive summaries for the semiannual reports during the 1980's were replete with instances in which a described problem was immediately followed by comforting language. For instance, in three successive semiannual reports covering the period April 1985 - September 1986, the IG notes problems with the Single Family Housing Program and tenant eligibility but follows them with descriptions of departmental action in first creating a task force, then in endorsing the task force recommendations, and finally, in implementing some of those recommendations.[47] In his Eighteenth Semiannual Report, Adams again reported serious problems with the Single Family Mortgage Insurance Program, but noted that "management's timely actions are a deterrent to fraud against the department."[48] This is not to say that the Inspector General should not point out positive actions taken by the agency, but it does show that the Executive Summary to many of these reports did not necessarily sound the clarion to the extent likely to awaken the interest of Congress.

One of the Congressional oversight panelists agreed. Thomas Mann of the Brookings Institution said:

> I listened to Mr. Dempsey and Mr. Adams, and I do not have any doubt that they believe their signals were crystal clear to the Congress, but for someone who is not an aficionado of these reports, I have to tell you they are long, vague, and boring, and they are not likely to get the attention

> of members of the Congress or of congressional staff. Under these circumstances, what is needed is more informal contacts between congressional staffers and IG staff. Frankly, the formal reports will always be too qualified and ambiguous to signal Congress.[49]

The HUD scandals have already resulted in improvements in reporting. OMB officials told the Subcommittee that OMB has encouraged the inspectors general to put their agencies seven biggest problems on the first page of their semiannual reports, together costs associated with those problems to catch the attention of busy congressmen.[50]

When questioned at the Subcommittee hearing about ways in which the semiannual reports could be restructured, Adams stated that his most recent reports have been changed in response to some of his criticism. To his credit, Adams has made significant improvements in his semiannual reports. The most recent report has a longer Executive Summary which highlights every problem discussed in more detail in the body of the report so that the reader can quickly determine the nature and severity of the issues being reported. Accordingly, if there was merit to the assertion that the warnings given by the HUD IG were unclear, that assertion has been dispelled by recent reports which take full advantage of the current atmosphere encouraging him to be more forthcoming in his criticism.

Adams has also decided to disclose in any audit report whether a problem noted constitutes, in his opinion, a material weakness for purposes of the Federal Managers Financial Integrity Act (FMFIA). This decision should help HUD and those who read the audit report and the FMFIA report in the early detection of problems that warrant serious attention. It is a decision that has not been imposed upon all Inspectors General but warrants their consideration as yet another tool in the proper detection and disclosure of problems.

IV. Confirmation Hearings

> The Senate's decisions on presidential appointments, political scientist Hugh Heclo has written, 'add up to a cumulative act of choice that may be at least as important as the electorate's single act of choice for president every four years.'[51]

To resolve a dispute over whether the President or the Senate should have the power to appoint, the framers of the United States Constitution provided in Article 2, Section 2 that the President be given that power, subject to the advice and consent of the Senate for all "Ambassadors, other public Ministers and Consuls, Judges of the supreme court, and all other Officers of the United States..."[52] The President is not thereby required to justify his nomination any more than the Senate is required to justify its decision regarding confirmation. Great deference has historically been given the

President by the Senate and, between 1789 and 1989, the Senate has only failed to confirm 15 Cabinet nominations.[53]

This power in the Senate is of particular importance to the inquiry into the problems at HUD because not only did the Senate have the opportunity to review reports of problems at HUD, it had a role in the selection of the persons upon whom blame for those problems is properly placed. Furthermore, not only does the confirmation process allow the Senate to scrutinize the appointee and to collect and impart information about the agency, it also provides an opportunity for members to direct agency activity."

Unfortunately there are no universal standards of explicit criteria by which to judge the competence, personal integrity, or fitness of people nominated by the President to serve in high-level agency positions. Because of the lack of standards and due to the independent power of each Committee, "...[t]he level of concern with a particular nomination and the criteria by which it is judged are very often affected by the mood of the moment."[54]

In general, the concerns about a nominee fall into three categories: conflict of interest, character and integrity,, and professional competence. On the issue of assessing competence, which is a major question concerning some former Senate-confirmed HUD nominees, the Senate has a conflicting record on whether it regards extensive and directly relevant experience essential for confirmation; in some cases it has considered this a positive attribute while in others it has not. However, expressions of concern about a nominee's qualifications have tended to be more politically motivated. "A Senator is not very likely to show much concern about the professional qualifications of a nominee if that individual is nominated by a President of the Senator's party, if he/she is on the same philosophical wave length as the Senator, or if he is from the Senator's home state."[55]

Panelists before the Subcommittee have told us the Senate finds it more difficult to reject someone who has no financial or ethical conflicts but does not seem to possess the most relevant skills for the position or has had questions raised about his or her competence. Some suggested that it might be helpful to establish detailed confirmation procedures, including requirements that the Committee make an affirmative finding that the individual is qualified by background and experience for the position he or she has been nominated, based on the Committee's own evaluation of the individual's qualifications. Mostly, the panelists cautioned us about the temptation to conduct quick reviews under pressure to fill a post.

Other panelists questioned whether the confirmation process is the most salient way to predict where problems will arise, stating that some of the most competent people have been those with whom the Congress has had the deepest disagreement on issues and that often, the issue has been over whether the laws have been implemented in the way that the Congress intended, not over an individual's competence.

One of the problems faced by the Senate is the sheer number of appointments that come before it for confirmation.[56] The total number of political appointments in the Cabinet agencies in 1989 was 3,460. It is difficult to expect the Senate to be able to carefully weigh the qualifications of such numbers of appointees, much less examine their policy views and possible conflicts of interest.

During the Pierce years, every person presented to the Senate for confirmation to a position at HUD but two were confirmed. One of those was Dean, when she sought confirmation to the position of Assistant Secretary for Community Planning and Development. She was rejected based upon her lack of qualifications, but other controversies surrounded her nomination and thus made her nomination unusual and thus more likely to undergo close scrutiny.[57]

Efforts have been made in the past to assist the President and the Senate in their review of nominees and potential nominees. The Standing Committee on Federal Judiciary of the American Bar Association, for example, serves in an advisory capacity to the President and the Senate Judiciary Committee by reviewing prospective nominees to federal judiciary vacancies.[58] This has become increasingly helpful with respect to the usually controversial appointments to the United States Supreme Court. In 1977, President Carter established a presidential advisory board under the Department of State to examine the qualifications of candidates under consideration for certain ambassadorial posts and to advise the department and the President of its findings. The 24-member board represented the fields of education, public affairs, government, and diplomacy.[59]

V. Conclusions and Recommendations

One expert told the Subcommittee that there are six key elements to effective oversight:

(1) Congress must establish clear and explicit performance goals for executive branch programs to facilitate the evaluation of program effectiveness and to facilitate the matching of goals to resources.

(2) There must be good communication between congressional committees and the agencies they oversee, including their inspectors general.

(3) Congress needs better advance oversight planning and coordination by its committees to avoid jurisdictional conflicts.

(4) Committee funding should be tied to their oversight agendas so as to ensure that the committees can adequately perform their oversight tasks.

(5) The agencies themselves need to conduct thorough, systematic, and comprehensive program evaluations.

(6) Congressional committees need to follow up on their oversight reports.[60]

The Subcommittee finds that many of these elements of effective oversight were lacking during the 1980s. Congress simply cannot assess the effectiveness with which HUD administers its programs without performance indicators and in this regard, the Subcommittee is encouraged by the interest of HUD in the development of output measures.

The Subcommittee also agrees that the sparsity of oversight hearings relating to HUD during the 1980s and near absence of contact with the HUD Inspector General suggest that communication was poor. The Subcommittee is also pleased by the improvements that have been made and intends to make further recommendations designed to institutionalize enhanced communication.

Regarding oversight planning, the Senate Banking Committee, as most Senate committees, did not develop a systematic oversight plan, tending more toward the "fire alarm" oversight approach which led to the instant investigation.[61] Consequently there is also no connection between an oversight plan and the committee budget. There would also appear to be some room for improvement in the communication between the several committees have jurisdiction over HUD, which planning would facilitate.

Finally, regarding the recommended elements of effective oversight enumerated above, the Banking Committee needs to prepare oversight reports once it begins a more systematic review of HUD programs and follow-up on those reports. Only in this way can the Senate be assured that HUD is operating in a manner consistent with congressional intent and free from abuse and mismanagement.

The absence of adequate oversight of HUD during the 1980s is particularly troubling given that trends suggest a growth in oversight beginning in the 1970s.[62] In the early 1970s, House and Senate rules were changed affecting committee jurisdictions and oversight responsibilities, reporting requirements increased, and additional staffing and resources were provided committees and subcommittees. In the latter 1970s, independent counsels and inspectors general were created to assist Congress in its check on the Executive Branch.[63] Heightened public distrust of federal agencies over waste and mismanagement had been spurred by Presidents Carter and Reagan and by aggressive investigative reporting. Furthermore, austerity caused Congress to scrutinize agency programs and expenditures.[64] Why then did it fail?

Witnesses before this Subcommittee, many of whom have spent several years studying congressional oversight as it is practiced today, have provided valuable insights as to what went wrong. Specifically, we were told that, in part, the abuses at HUD continued unabated because (1) Congress did not pay attention to a number of reports which highlighted on-going problems at HUD, especially the IG semiannual reports; (2) the Senate confirmation process is conducted in a less than rigorous fashion; and (3) due to perceived disincentives by the Congress in pursuing oversight activity, it did not do so in any persistent fashion.

There are a number of possible explanations for the absence of congressional review of the warnings given by the HUD Inspector General and others during the 1980s. Some, such as lack of clarity of warning, have been discussed. Also, Congress had other more pressing issues to consider; housing was simply not a priority issue. As one witness told the Subcommittee: "I believe that HUD will always be the natural enemy of the Treasury."[65]

But there are more generic factors which dissuade the Congress from engaging in oversight or which make oversight ineffective when it is exercised. For members of Congress, time is critical. Continuous, in-depth oversight takes significant amounts of time and attention. Increasing pressures on Congress to devote time to new problems leaves little to the analysis of on-going programs. Congress also finds oversight unglamorous, unless it turns up something which can grab media attention. "Congress lacks the electoral, political, and institutional incentives for oversight. More political mileage can be gained by concentrating on legislating programs."[66] Other factors include the feeling that federal agencies are "impenetrable mazes," disagreement over how to measure oversight, and concern that oversight merely exposes more problems rather than correcting ones already uncovered.[67]

Effective oversight is also hindered by the alliances that develop among the members, the staff, and agency managers. Such relationships hinder an objective and critical appraisal of an agency's programs.[68]

This investigation has led the Subcommittee to the conclusion that a reassessment of HUD and Congress' relationship with HUD is in order. While the current atmosphere has resulted in a great deal of interplay between the current HUD administration and the IG with Congress, we must look beyond that in recognition of the fact that HUD is a complex agency managing many programs that are difficult to manage free of fraud and abuse. It is incumbent upon Congress to make the oversight of the agency like brushing one's teeth. The following recommendations reflect that view.

A. Mission of HUD

The Subcommittee began its inquiry by inviting former Secretaries and other former top officials to discuss the mission of HUD, how it has evolved, and how it may have led to the problems the agency has encountered. The original mission of HUD was to "provide a decent home in a suitable environment for every American family."[69] As evidenced by the reaffirmation of that statement in the Affordable Housing Act of 1990 currently before Congress, it still reflects the will of Congress. Nonetheless, HUD's mission has changed over time. One witness told the Subcommittee that "if there was a mission [during the 1980s], it was to eliminate HUD."[70] In the past, HUD has been given the mission to play an active role in urban and community development. In 1968, Congress was sufficiently concerned over the production of housing that it enacted quantifiable goals of 26 million units of housing within 12 years, of which 6 million units were to be for low and moderate income persons.[71] There is current debate over whether the housing stock needs replenishment. Some argue that we face a critical need for new housing, while the current administration seems to favor home ownership initiatives over production. There is also debate over whether much of the responsibility and funding decisions of HUD should be transferred to the states and local governments who are closer to the needs of their citizens.

Concurrent with these debates is the fact that in light of the HUD scandals, some programs have been terminated or suspended. Secretary Kemp has indicated that he views HUD as an agency designed to help the poor and has terminated two programs that he believes were aimed at a higher income group: Title X and the Retirement Service Center program. He has suspended the multi-family co-insurance program to be replaced by a delegated processing system. Secretary Kemp told the Subcommittee that he believes HUD's mission is too broad, stating "I think (Congress) asked too much of HUD. We wanted FHA to insure hospitals in Chicago and in New York and in Miami. We asked HUD to develop real estate. We got into the AD&C loan business. We got into the Title X land development program that built golf courses."[72]

Under Secretory DelliBovi told the Subcommittee that HUD intends to complete a comprehensive program analysis of existing and new programs.[73] As DelliBovi points out, this will be the first operational review of some of these programs since their inception. Given the complexity of some of these programs and history of abuse, and given that in the wake of the recent scandals, a unique opportunity exists for a re-examination of the mission of HUD, Congress must become involved in that review to help establish clear policy directives to the agency.

RECOMMENDATION:

The Senate Banking Committee or the Subcommittee on Housing and Urban Affairs should undertake an analysis of the mission of

HUD as part of a monitoring HUD's announced intention to completely review its programs, to determine the role HUD should play in meeting the housing needs of this country.

B. Congressional Oversight

One lessen learned by the Subcommittee is that congressional oversight should not wait until problems at an agency such as HUD reach crisis levels. Rather, Congress should become more attuned to the problems of program implementation at the design stage and must be certain that the congressional intent for the program is clear.

RECOMMENDATION:

Congressional oversight ought to be considered at the policy-making stage as a principal means of avoiding foreseeable breakdowns in programs and management.

Moreover, HUD must itself become more involved in the assessment of its needs to implement new programs before they are created so that both the agency and the relevant committee's can take appropriate actions to ensure that the agency has the necessary capacity to implement the program.

RECOMMENDATION:

Prior to the enactment of any new program or substantial change in an existing program, HUD should prepare a "housing impact statement." This statement would identify the effect that the Congressional proposal would have on existing and future HUD staffing and management resources and on existing HUD programs.

C. Oversight Hearings

> And I'll tell you, when the Congress is interested, it sends the fear of God into the executive branch; from the career levels up to the political levels, people worry.[74]

Conducting oversight is not usually glamorous work, and unless it serves a Member's constituency or attracts press, effective oversight -- meaning long-term and continuous -- doesn't happen as often as it should. When it does occur, it is usually after the money has been misused and the problem is out of control. Consequently, the Subcommittee feels that it is important to build oversight into the committee structure and processes so that it is conducted more regularly.

It is not surprising that the Congress would miss the signals coming from the IG, GAO, and FMFIA reports when the number of oversight hearings held during Secretary Pierce's tenure were minimal. For example, the Senate Committee on Banking, Housing, and Urban Affairs held only one oversight hearing on housing during this time. While the Subcommittee on Housing and Urban Affairs held 22 hearings, 16 of them occurred during Pierce's last two years after Senator Alan Cranston (D. California) became subcommittee chairman. But by then, most of the Subcommittee's attention had begun to focus upon the development of new affordable housing legislation, which finally gained enactment just before the release of this report.

Nonetheless, former Senator William Proxmire, who served as chairman of the Senate Committee on Banking, Housing, and Urban Affairs and of the Senate appropriation Subcommittee with responsibility for HUD the last two years of the Pierce Administration, told the House Subcommittee on Employment and Housing how his committees missed the abuses at HUD. "The answer to that is simple. We had no idea it was going on." In his view, the committees ignored the warnings.[75]

One panelist told us, "The HUD problem is merely the symptom of a deeper incapacity in the system as a whole to sustain critical, long-term attention on executive branch management .. scrutiny must become a habit, like brushing your teeth every day."[76] One way to make oversight habit-forming is to take advantage of the reporting requirements Congress has imposed upon the agency and its inspector general.

At its last hearing, the Subcommittee invited the Inspector General to present his latest semi-annual report. The Subcommittee also invited the Under Secretary to present the Secretary's semi-annual report.[77] The Subcommittee was thus able to focus upon the most current problems facing HUD and determine which, if any, warranted further attention.

RECOMMENDATION:

The Senate Banking Committee or the Subcommittee on Housing and Urban Affairs should hold hearings to receive each Semiannual Report of the HUD Inspector General, each Semiannual Report of the HUD Secretary, and the Department's annual FMFIA report.

In this way, it is hoped that problems will be highlighted sooner and corrective action taken earlier, before they grow to "scandal" proportions. Further along these lines, the Subcommittee recommends that the appropriation committees also hold annual hearings on these reports. In that many of the internal and financial control weaknesses identified in the FMFIA report will take not only a lot of time but money to correct, it seems especially appropriate that the appropriations subcommittee responsible for HUD hold hearings, or at least question HUD during appropriation hearings, on HUD's progress and plans for corrective action on these items. The Subcommittee feels that this type of regular attention to oversight will go a long way in keeping HUD's attention focused on its problems and its efforts geared towards fixing them.

This is not to say that attention to these reports constitutes sufficient oversight, as committee staff attention must also be given to GAO reports critical of HUD programs. GAO is, after all the principal investigative tool available to Congress and many of its reports are in response to committee or committee member requests. Accordingly, equal consideration should be given to hearings designed to focus upon critical findings of GAO as well.

D. Oversight Staff

Information is critical to practicing oversight. Obviously, without it the Congress can never know how programs are being managed and if its intent is being carried out. Receiving the information is only half of the equation: digesting, analyzing, and monitoring it continuously is what makes oversight effective. As clearly shown by the Subcommittee hearings, no dearth of information exists informing the Congress about HUD programs. Not only does the Congress receive the IG's semiannual reports and the agencies' FMFIA statements, but it also receives numerous other IG and GAO reports reviewing specific HUD programs as well as other reports which HUD is mandated by law to provide. Added to this are the hundreds of reports produced by trade and industry associations, "think-tank" groups, and other institutions which make their way to Congress ever year, burying staff in information both solicited and unsolicited, most of which relates to policy issues rather than effective implementation of programs.

In addition, HUD is undertaking a substantial self-evaluation involving internal studies of many of its programs and internal controls. Secretary Kemp also plans to clear the enormous backlog of problems he inherited in accordance with a timetable to be monitored. Those studies and corrective actions will require the attention of congressional staff to determine whether they are adequately addressing perceived problems and whether solutions are in compliance with the will of Congress.

Clearly the problem is not a lack of data or information to analyze, but possibly one of information overload. If one couples this with the limited number of committee staff and the fiercely competing demands of their time, it is understandable how difficult, if not impossible, it is for the Congress to process this amount of information in order to identify significant problems occurring at the agency. Complicating the effectiveness of oversight further is the high level of congressional staff turnover and consequent lack of experience with complex and technical areas.[78] Nonetheless, the Subcommittee agrees with the assessment of Senator Proxmire who concluded that a staff member must be designated to read these reports and keep the staff director, the chairman, and the committee aware of problems at agencies within the jurisdiction of the committee.[79]

RECOMMENDATION:

The Committee on Banking, Housing, and Urban Affairs should designate a staff person responsible, on a full-time basis, for developing an oversight plan for the committee, collecting and analyzing GAO, IG and agency reports, especially FMFIA, and issuing oversight reports and conducting follow-up on those reports. In addition, this person would act as a liaison with the IG and GAO concerning these reports and any other matters important to call to the attention of the Committee. At the very least the Subcommittee on Housing and Urban Affairs should designate a staff person to perform such duties with respect to HUD.

E. Oversight planning

The House also provides a greater emphasis upon the importance of oversight and a clearer delineation of oversight responsibilities. While Senate rules provide committees with comprehensive policy oversight responsibilities, since 1974 the House rules have authorized committees to establish a separate oversight subcommittee or to require its subcommittees to engage in oversight activities.[80] During the 1970s, attempts were made to impose similar requirements in the Senate, but all failed. In 1976, the Temporary Select Committee to Study the Senate Committee System rejected the idea of requiring the creation of oversight subcommittees, determining that the requirement would be difficult to implement and would be inconsistent with the committee's view that "the legislative and oversight functions should not be separated."[81] It may be that the Senate Subcommittee on Housing and Urban Affairs is in the best position to conduct oversight of HUD, but given the number of problems that have occurred at that and other agencies since 1976, the wisdom of the conclusion reached in that year should be re-examined.

RECOMMENDATION:

The Senate should reconsider a requirement that certain committees establish a separate oversight subcommittee or require their subcommittees to engage in oversight activities. In the alternative, the Senate Banking Committee should consider such changes in its rules.

F. Multiple committee jurisdiction

As mentioned, there are multiple committees with jurisdiction over HUD. This has long been seen as an impediment to effective oversight. The risk always exists that one committee will usurp the authority of the other, thus creating duplication of effort and misunderstanding. On the other hand, rather than too much oversight, multiple jurisdictions can create a deference to one another which actually results in neither fulfilling the oversight role. Until 1987, when the practice was discontinued, the House had encouraged communication and coordination of effort by requiring its committees to report their oversight plans to the House Committee on Government Operations at the beginning of each Congress.[82] The Senate has had no such requirement.

RECOMMENDATION:

The Senate should reconsider a change in its rules to require its committees to prepare a two-year oversight plan and provide a copy to the Senate Committee on Government Affairs in advance of each new Congress.

G. Performance Measures

During the course of the Subcommittee investigation, witnesses were asked their view of the use of output or effectiveness indicators as a means by which HUD and Congress could gauge the manner in which HUD or any other federal agency is carrying out congressional intent in its administration of programs. Many were invited to provide the Subcommittee with their recommendations regarding the creation of a list of measures by which that effectiveness could be assessed. The interest of the Subcommittee in this regard is consistent with the first of the six key elements to effective oversight listed above by one of our witnesses: the need for the clear articulation of congressional goals upon which program effectiveness can be measured.

One housing expert, Morton Schussheim, provided the Subcommittee with a list of indicators that might reveal trends or practices that would merit attention. These include:

(1) changes in the supply of assisted housing or number of assisted households;

(2) changes in the numbers of persons on waiting lists;

(3) rising default rates on FHA-insured homes; and

(4) rising inventories of assigned mortgages and HUD-owned property.[83]

At its April 23, 1990 hearing, the Subcommittee requested OMB to compile a list of data which could be used by Congress to gauge the performance of HUD programs. OMB suggested the following:

(1) General Economic Variables
  (a) Home price appreciation
  (b) Mortgage interest rates
  (c) Level of employment
  (d) Composite Index of leading indicators

(2) Specific Portfolio Variables
  (a) Median loan-to-value ratio
  (b) 90 day delinquency rate
  (c) Default or claim rate
  (d) Average loss ratio on sales of foreclosed properties

OMB has also indicated that it will soon propose to the Office of Economic Policy of the United States Department of Treasury that it issue quarterly figures for each of these variables for use by HUD and Congress in assessing HUD programs. It is OMB's hope that the general economic variables will allow HUD to determine whether underwriting standards should be loosened and that the specific portfolio variables will provide good indicators of the state of the FHA Fund and the general quality of loans guaranteed by FHA.

Under Secretary DelliBovi indicated to the Subcommittee that Secretary Kemp was interested in outputs as well and that HUD was in the process of developing goals for its programs and the data that would permit HUD to measure the ability of HUD to meet those goals.

The subcommittee has also recently learned of legislation introduced by Senator William Roth (R. Delaware) which would require each agency to establish a performance standards and goals plan for each major expenditure category in its budget and submit the same with its budget to PMB, the President and Congress. The legislation would also require Congress to specify performance standards and goals for each expenditure in legislation which authorized or appropriates funds.

RECOMMENDATION:

The Congress should formulate goals and performance measures for federal programs when they are created or authorized. Each federal agency should develop program goals and performance measures and submit a plan for their accomplishment with the agency budget request submitted to OMB. In addition, Congress and the federal agencies should determine data to be collected to support those goals and measures, to ensure that they are

consistent with congressional intent and will facilitate the subcommittee's oversight responsibilities.

At the very least, HUD should develop such goals and performance measures for its programs and a plan for their accomplishment. Progress in meeting those goals should be reported to Congress on a regular basis. In this fashion, Congress can conduct an output analysis of HUD and determine its needs in providing assistance to those it is created to serve.

RECOMMENDATION:

The Inspector General Act should be amended to require the Secretary's semiannual report to reflect the goals for each program under HUD and the measure of the effectiveness with which HUD has attained those goals during the reporting period, together with an assessment of actions to be undertaken to achieve those goals.

The Subcommittee should also determine the need, if any, to codify any such goals or data and should require the inclusion of the measure of the effectiveness of programs in the Secretary's semi-annual report.

H. The Seven-Day Letter

The evidence shows that the procedure adopted by Congress whereby it and the agency is to be notified by the Inspector General of serious problems is not working. One reason for this is that an inspector general may be unwilling to jeopardize his relationship with agency management by giving such a warning to Congress. But another problem discussed above seems to be a lack of understanding regarding Congressional intent. Some believe that the report is to be used only where the agency is covering up a problem while others have no idea what "flagrant" means. Given that the IG's seem to be responding to the recent process put in place by OMB for the disclosure of problems, perhaps uniform language is in order.

RECOMMENDATION:

The Inspector General Act should be amended to clarify Congressional intent regarding the use of the seven-day letter.

I. Confirmation

Although the Subcommittee feels that these changes in the oversight process will go a long way in alerting Congress earlier to significant or growing problems at HUD, it will not go far enough in assuring that government programs are safe from fraud and abuse. We know and have been told time and again during these hearings, programs cannot be run efficiently and effectively unless the people in charge of them are competent, experienced, and care about the mission of the agency in which they will serve. This is especially true for the agency head and his or her team since they are the "first line of defense" in overseeing and protecting government programs. As these hearings have pointed out, too often the Senate has confirmed nominees with little regard for their competence for the job. Understandably, there is concern that the President exercise his maximum authority in selecting the management team he wants. But one way for the Congress to assure itself that the scandals which occurred at HUD do not happen again, is to make sure that the nominees who are confirmed for these positions are well qualified for their jobs.

During the Pierce Administration, the Senate confirmed persons to top positions at HUD who either lacked the background in housing or the requisite interest in housing to ensure that the agency fulfilled its mission. Worse, many of these appointees allowed the agency to become the dumping ground for political "must-hires" in lesser non-career positions, who lacked either background or skills in housing. The problems at HUD provide the Senate with the opportunity to experiment with a concept that may assist it in preventing the reoccurrence of this aspect of the problems at HUD. The Senate Banking Committee needs to draw upon the wealth of experience and knowledge of housing and the management of housing programs that exists. Many of these experts testified before the Subcommittee. They include former top HUD officials who demonstrated a continuing interest in the vitality of HUD and its programs, academicians in housing and public administration, and housing experts for various associations. Obviously care must be taken that the members of an advisory board created for this purpose exercise their responsibilities as free from political considerations as possible and that conflicts of interest be avoided. But a small group of these individuals may afford the committee a perspective previously limited to judicial and ambassadorial nominees that would be helpful in its review of nominees, both in terms of qualifications and policy.

RECOMMENDATION:

The Senate Committee on Banking, Housing and Urban Affairs should establish an ad hoc advisory board to provide confidential recommendations to the Committee members regarding the qualifications of persons seeking confirmation for appointment to positions at the Department of Housing and Urban Affairs. The board would provide a similar service to that provided by the American Bar Association in its review of federal judiciary nominees. Although care would obviously have to be taken in appointing Board members in order to avoid direct conflicts of interest, those who would be appointed to this Board would be acknowledged housing specialists and academicians familiar both

with the department and housing programs and the administration thereof.

The Subcommittee sees the role of the Board as one in which it would simply provide very knowledgeable input as to the qualifications of HUD nominees in addition to the other information gathered by the Committee through its current procedures. While some might argue that the Board would only cause unnecessary delay, speed should not be a factor except in the most unusual of circumstances. Senator Robert Byrd (D. West Virginia) once warned of the disservice the Senate does to the President by rushing a nomination. "If damaging information about a nominee's past is to be found, or serious character flaws are to be uncovered, better that it become public knowledge before the individual is confirmed than after."[84]

ENDNOTES

1. Charles Dempsey, former Inspector General, HUD, Testimony, Hearings, Vol. 2 May 8, 1990 at p. 481.

2. Id. at p. 479.

3. Kaiser, F., "Congressional Oversight of the Presidency," The Annals of the American Academy of Political and Social Science, 499:77 (September 1988).

4. Congressional Oversight Manual, Congressional Research Service, November 1989, p. 1. Other acts which assign oversight duties to Congress include the Intergovernmental Cooperation Act of 1968, the Legislative Reorganization Act of 1970, the Federal Advisory Committee Act of 1972, and the congressional Budget and Impoundment Control Act of 1974.

5. Id., at p. 8; Oleszek, W., "Congressional Procedures and the Policy Process," at p. 268.

6. National Academy of Public Administration, "Congressional Oversight of Regulatory Agencies: The Need To Strike a Balance and Focus on Performance," at p. 10.

7. While it has been reported that there were as many as 84 committees and subcommittees having jurisdiction over HUD, the principal committees of jurisdiction are the Senate Committee on Banking, Housing, and Urban Affairs, the Senate Committee on Governmental Affairs, the Senate Budget Committee, and the Senate Committee on Appropriations, the House Committee on Banking, Finance and Urban Affairs, House Committee on Government Operations, House Committee on the Budget, and House Committee on Appropriations, and their respective Subcommittees which have primary focus upon HUD. Shuger, S., "File Before Reading. When the inspector general speaks, nobody listens," The Washington Monthly, January 1990 at p. 24.

In 1989, the House Subcommittee on Employment and Housing requested the HUD Inspector General to provide it on a weekly basis with a copy of each audit it released that week. According to staff of the Senate Committee on Governmental Affairs, the Committee has taken upon itself to routinely read every semi-annual report of each Inspector General.

8. The Inspector General Act of 1978, 5 U.S.C. sec. 208 (1978). The 12 agencies were the Departments of Agriculture, Commerce, Housing and Urban Development, Interior, Labor, and Transportation; and the Community Services Administration, Environmental Protection Agency, General Services Administration, National Aeronautics and Space Administration, Small Business Administration, and Veterans Administration. Offices of Inspector General had been earlier created at the Department of Health, Education and Welfare pursuant to 42 U.S.C. 3521 (1976) and the newly created Department of Energy, pursuant to 42 U.S.C. 7138 (1977). In 1988, the Inspector General Act was amended o increase to 59 the number of federal entities having an Office of Inspector General, including the Departments of Defense, State, and Treasury.

9. Id., Section 4(a)(5).

10. Report to the Congress, Office of the Inspector General, HUD, for the six month period Oct. 1, 1983 to March 31, 1984, No. 11; Report to the Congress, Office of the Inspector General, HUD for the six month period April 1, 1984 to Sept. 30, 1984, No. 12; Report to the Congress, Office of the Inspector General, HUD, for the six month period Oct. 1, 1984 to March 31, 1985, No. 13; Report to the Congress, Office of the Inspector General, HUD, for the six month period April 1, 1985 to Sept. 30, 1985, No. 14; Report to the Congress, Office of the Inspector General, HUD, for the six month period Oct. 1, 1985 to March 31, 1986, No. 15; Report to the Congress, Office of the Inspector Generai, HUD, for the six month period April 1, 1986 to Sept. 30, 1986, No. 16; Report to the Congress, Office of the Inspector General, HUD, for the six month period April 1, 1988 to Sept. 30, 1988, No. 20; Report to the Congress, Office of the Inspector General, HUD, for the six month period Oct. 1, 1988 to March 31, 1989, No. 21; Report to the Congress, Office of the Inspector General, HUD, for the six month period April 1, 1989 to Sept. 30, 1989, No. 22.

11. "Thomas Demery, Section 8 Moderate Rehabilitation Program," Report of Investigation, Office of the Inspector General, No. HM 1-1054, April 17, 1989.

12. For example, J. Michael Queenan, former director of Housing Development in Denver, advised the director of the Richland, Washington Housing Authority that they had been awarded even before HUD headquarters had notified the Seattle Regional Office.

13. Joseph Strauss, a former Special Assistant to the Secretary, received of $1.3 million in such fees. Richard Shelby, a former White House assistant in the personnel office and currently on the staff of the Republican Congressional Campaign Committee, received $442,000. Fred Bush, an active Republican fund raiser and the current nominee for Ambassador to Luxembourg, received $260,000. Michael Karen, former Deputy Assistant Secretary for Multifamily Housing, received $420,000. Former Senator Ed Brooke received $183,000. Former Interior Secretary James Watt received $300,000. Former Attorney General John Mitchell received $75,000. The report also detailed the contributions made by developers and other participants to a charity called Food for Africa. The Assistant Secretary of Housing at the time, Tom Demery, had been an official of the charity. These contributions amounted to 50 percent of the funds raised by the charity between 1986-88, including $36,000 from Mr. Queenan; $15,000 from Mr. Strauss; $19,000 from Benton Mortgage Company, a co-insurance lender on approximately 45% of mod rehab projects; and $27,000 from Real Property Services Corporation, who was a major participant in HUD programs.

14. "Thomas Demery, Section 8 Moderate Rehabilitation Program," Report of Investigation, Office of the Inspector General, No. HM 1-1054, April 17, 1989 at p. .

15. General Accounting Office, "Increasing HUD Effectiveness Through Improved Management", January 10, 1984, (GAO/RCED-84-9).

16. General Accounting Office, "HUD Needs to Better Determine Extent of Community Block Grants' Lower Income Benefits", November 1982, GAO/RCED-83-15;

General Accounting Office, "Rental Rehabilitation With Limited Federal Involvement: Who Is Doing It? At What Cost? Who Benefits?' March 1985, GAO/RCED-83-148.

17. General Accounting Office, "Interim Report on GAO's Review of the Urban Development Action Grant Program", March 1983, GAO/RCED-83-126; General Accounting Office, "Insights Into Major Urban Development Block Grant Issues", March 1984, GAO/RCED-84-55; General Accounting Office, "The Urban Development Action Grant Application Selection System: Basis, Criticisms, and Alternatives", March 1985, GAO/RCED-85-77.

18. General Accounting Office, "HUD's Loan Servicing Contracts for Multifamily Mortgages Need Better Management", March 1983, GAO/RCED 83-78.

19. General Accounting Office, "Improving the Process for Selecting Loan Management Set-Aside Funds to Multifamily Housing Projects", November 1984, GAO/RCED-85-29.

20. General Accounting Office, "Housing for the Elderly: HUD's Cost Containment Program Could Be More Effective", September 1986, GAO/RCED-86-106.

21. General Accounting Office, Housing Programs: Funding Approach for HUD's Section 8 Certificate Program Needs Changing", April 1988, GAO/RCED-88-136.

22. The Inspector General Act of 1978, sec. 5(d).

23. Id.

24. Paul Adams, Inspector General, HUD, Testimony, Hearings, Vol. 2, May 8, 1990 at p. 482; DEmpsey at p. 482.

25. Frederick Kaiser, Congressional Research Service, Testimony, Hearings, Vol. 2, May 8, 1990 at p. 481.

26. "OIG Use of Seven-Day Letter Reporting Provision of the IG Act of 1978 (Section 5d)," PCIE Survey, Sherman Funk, Chairman, Inspections and Special Reviews Committee, June 1986. In that report, the Committee found that the seven-day letter had been used as follows:

(1) Once by the IG of the Department of Agriculture regarding the appropriateness of using FY 1982 funds to contract for assistance to be provided in FY 1983.

(2) Twice by the IG of the Department of Education to advise Congress that certain proposed legislative amendments would pose a serious threat to the agency's ability to prevent fraud, waste, and abuse. In one case the IG believed the letter helped defeat the amendment.

(3) Once by the IG of the Department of Health and Human Services to inform Congress of a $14 million shortfall in the IG's appropriation due to a technical error.

(4) Twice by the IG of the Department of Interior regarding the propriety of using certain funds for a specified project and regarding a disagreement with the Government of Guam's policy to collect gross receipts taxes on certain export sales.

(5) Once by the IG of the Department of Labor to voice concerns to Congress over legislation for a labor program.

(6) Once by the IG of the Small Business Administration to inform Congress that it lacked sufficient funds to fulfill a special congressional request.

27. Id.

28. Senate Committee on Government Affairs, Hearings, September 28, October 3 and 5, 1989.

29. President's Council on Integrity and Efficiency, "Survey of IG Use of Seven-Day Letter, June 1986 to Present," Office of Management and Budget.

30. Sherman Funk, Inspector General, Department of State, Testimony, Hearings, Senate Committee on Government Affairs, September 28, 1989 at p. 56.

31. Dempsey at p. 482.

32. Adams, May 8, 1990 at p. 482.

33. President's Council on Integrity and Efficiency, "Legislative History of Section 5(d) of the Inspector General Act of 1978".

34. Id.

35. Id.

36. Dempsey at p. 482.

37. President's Council on Integrity and Efficiency, "Suggested Criteria and Procedures for Early Warning Notifications," Office of Management and Budget, February 26, 1990; Letter from Frederick Kaiser to Chairman Graham in response to questions posed at the May 8, 1990 hearing of the Subcommittee, June 6, 1990 at p. 9.

38. Kaiser at p. 483.

39. House Committee on Governmental Operations, Establishment of Offices of Inspector General at pp. 13-14.

40. Funk at pp. 56-57.

41. PCIE Survey, "OIG Use of Seven-Day Letter Reporting Provision of the IG Act of 1978 (Section 5d)," Inspections and Special Review Committee, June 1986.

42. Funk at p. 57.

43. In addition to concerns discussed here over the clarity of the warnings, the April 26 report also received severe criticism during the House investigation for having focused on Thomas Demery to the comparative exclusion of Pierce and Dean. Members believed that the investigation surrounding that report failed to uncover the nature of the Mod Rehab decision-making process and unfairly laid too much blame upon Demery, who testified that he was not even at HUD during most of the period covered by the report and that, in any event, he had instituted procedures that had improved the Mod Rehab funding procedures. Adams, Testimony, House Hearings, June 16, 1989 at p. 493-515.

44. Senator William Roth (R. Delaware), Hearing, Senate Committee on Government Affairs, September 28, 1989 at p. 54.

45. Dempsey at p. 480.

46. Report to the Congress, Office of Inspector General, HUD, for the six month period Oct. 1, 1986 to March 31, 1987, No. 17 at p. 1.

47. "The Department is taking steps to address these problems ... This comprehensive approach has the potential to materially improve policies, procedures, and controls and will go a long way to minimize the abuses this Department has faced for a number of years." Report to the Congress, Office of the Inspector General, HUD, for the six month period April 1, 1985 to Sept. 30, 1985, No. 14 at p.1; "However, I am pleased to report that the Secretary has endorsed the recommendations of the Single Family Task Force...Once fully implemented, these procedures should effectively address many of the systemic weaknesses noted in our audits and investigations." Report to the Congress, Office of the Inspector General, HUD, for the six month period Oct. 1, 1985 to March 31, 1986, No. 15 at p. 1; "The Department began implementing the recommendations of the Secretary's Single Family Task Force... The Department is also taking more aggressive action against those who abuse Single Family Programs." Report to the Congress, Office of the Inspector General, HUD, for the six month period April 1, 1986 to Sept. 30, 1986, No. 6 at p. 1.

48. Report to the Congress, Office of the Inspector General, Report to the Congress, HUD, for the six month period April 1, 1987 to Sept. 30, 1987, No. 18 at p. 3.

49. Thomas Mann, Director, Government Studies Program, Brookings Institution, Testimony, Hearings, Vol. 2, May 8, 1990 at p. 521.

50. William Diefenderfer, Deputy Director, OMB, Testimony, Hearings, Vol. 2, April 23, 1990 at p. 159.

51. Congressional Quarterly, "Congress A to Z," 1988 at p.11.

52. U.S. Const. Art. 2, Sec. 2.

53. Garcia, R., "Cabinet and Other High Level Nominations that Failed to be Confirmed, 1789-1989," CRS No. 89-253, April 14, 1989.

54. MacKenzie, p. 97.

55. MacKenzie, p. 117.

56. The Senate's confirmation power has been characterized as "little more than a bureaucratic chore" given that the number of appointments it must consider is so vast -- 40,000 in 1986. Congressional Quarterly Inc., "Congress A to Z," 1988 at p. 12.

57. Ironically, given the fact that allegations of abuses in the Technical Assistance Program only received intense congressional inquiry this year (See the discussion of abuses in this program in "The Pierce Years", infra, one of the major controversies surrounding Dean at the time of her confirmation hearing in 1987 was allegations of her use of the Secretary's autopen to make awards under the program which were the subject of severe criticism by the HUD Inspector General. One congressional source familiar with the probe was quoted as saying "Everybody is looking for the smoking gun; in other words, fraud ... It's not so much that it is the use of power and a lack of basic integrity." Poole,I.,"HUD aide promotion stalled in Senate," The Washington Post, November 10, 1987 at p. A3.

58. Upon the creation of a federal judiciary vacancy, the Attorney General submits the name of a prospective nominee to the ABA Standing Committee on Federal Judiciary. The prospective nominee completes the ABA-designed Personal Data Questionnaire, which assists the committee in its investigation of the integrity, competence, and judicial temperament of the prospective nominee. The committee interviews the prospective nominee and others and confidentially renders to the Attorney General its rating of the prospective nominee as well qualified, qualified, or not qualified. If the prospective nominee is nominated by the President and if the Senate Judiciary Committee requests, the ABA committee submits its rating for the public record. Similar, but somewhat more elaborate investigation is made with respect to prospective nominees to a vacancy on the United States Supreme Court and an ABA representative appears at the Senate confirmation hearing to explain the rating given. The ABA Committee has provided the Senate Judiciary Committee with its opinion of prospective nominees to federal judiciary vacancies since 1948 and has been consulted by every President with respect to virtually every nomination since 1952. American Bar Association, "Standing Committee on Federal Judiciary. What It Is and How It Works," June 1988.

59. The board was created by Executive Order 11970, February 6, 1977. The board was abolished by Executive Order 12299, March 17, 1981.

60. Richard Wegman, Chair, NAPA Congressional Oversight Panel, Prepared Statement, Hearings, Vol. 2, May 8, 1990 at pp. 511-512.

61. Not all would agree that the "fire alarm" approach is inadequate. Some scholars contend that it is far more effective than the "police patrol" approach and argue that "a perfectly reasonable way for Congress to pursue its objectives is by ensuring that fire alarms will be sounded." They contend that Congress must give discretion to the agencies, rather than attempting to anticipate every contingency or circumstance and rely upon affected constituencies to sound the alarm when congressional intent is thwarted. Mathew D. McCubbins and Thomas Schwartz, "Congressional Oversight Overlooked: Police Patrol versus Fire Alarm," American

Journal of Political Science, 28:165, 196, February 7, 1984. Unfortunately, this reasoning requires Congress to actually respond to the fire alarm once sounded. Some would argue that the bell rang loud and long at HUD before it was noticed.

62. The 1970 amendments to the Legislative Reorganization Act of 1946 required most committees to issue biennial oversight reports, strengthened the role of the Congressional research Service, and empowered the General Accounting Office to conduct program reviews. Aberbach, J., Keeping a Watchful Eye. The Politics of Congressional Oversight, The Brookings Institution, 1990, at p. 27.

63. Kaiser, F., "Congressional Oversight of the Presidency," The Annals of the American Academy of Political and Social Science, 499:88-89 (September 1988).

64. Oleszek at p. 276.

65. Robert Wood, former Secretary of HUD, Testimony, Hearings, Vol. 1, January 30, 1990 at p. 20.

66. Oleszek, p. 278.

67. Oleszek at pp. 277-278.

68. Id. at p. 270.

69. The Housing Act of 1949, 42 U.S.C. 1441.

70. Philip Brownstein, former Federal Housing Commissioner, Testimony, Hearings, Vol 1., January 30, 1990 at p. 43.

71. The Housing and Urban Development Act of 1968, 42 U.S.C. 1441a.

72. Jack Kemp, Secretary of HUD, Testimony, Hearings, Vol. 2, May 16, 1989 at p. 609.

73. Al DelliBovi, Under Secretary of HUD, Testimony, Hearings, June 29, 1990 at pp. 100; 102.

74. Diefenderfer at p. 158.

75. Proxmire at p. 10.

76. Hugh Heclo, Clarence J. Robinson Professor, George Mason University, Prepared Statement, Hearings, Vol. 2, April 23, 1990 at p. 180.

77. CITE June 29, 1990 hearing and subjects discussed.

78. The Congressional Management Foundation study "indicated that two out of three legislative assistants have held their positions for less than two years...", National Academy of Public Administration, "Congressional Oversight of Regulatory Agencies: The Need To Strike a Balance and Focus on Performance," at p. 14, quoting

from Pianan, E., "Bleak House," Washington Post, National Weekly Edition, December 7, 1987, at p. 32.

79. Proxmire at p. 12.

80. House Rule X.

81. Congressional Research Service, Congressional Oversight Manual, November 1989 at p. 120.

82. Unfortunately, this system of coordination did not work as well as might have been intended since it was "not used by the House leadership to establish oversight priorities or settle jurisdictional disputes between competing committees." NAPA at p. 17.

83. Schussheim at pp. 9-10. Other indicators listed are:

> (1) A rise in the number of projects whose owners take steps to prepay their mortgages and leave the assisted housing inventory; or owners or landlords who stop taking families with certificates or vouchers;
>
> (2) Increases in the number of HUD-subsidized projects placed on a watch list for financial difficulties;
>
> (3) Increases or decreases in vacancies and rent collection rates at public housing;
>
> (4) Results of efforts to encourage resident management and ownership of public housing;
>
> (5) Changes in the incomes of program beneficiaries that may require larger subsidies;
>
> (6) Rent increases in various areas that may result in higher fair market rents and higher subsidy payments;
>
> (7) Staffing patterns in HUD to determine whether all mandated programs are assigned appropriate and sufficient staff.

84. Remarks of Senator Robert C. Byrd (D. W.Va.), Congressional Record, daily ed., July 29, 1987, S10835.

PART THREE:
THE HUD SCANDALS

The legacy of the administration of the Department of Housing and Urban Development under Secretary Samuel Pierce will be one of mismanagement, abuse, and favoritism. Pierce served as head of the agency throughout the Reagan Administration, putting forth presidential policies which reduced the role of the federal government in housing and which favored deregulation and privatization.

However, the Pierce Administration did more than reduce the role of the agency. Pierce and a handful of political appointees created a culture at HUD whereby programs designed for the poor became programs for the benefit of the politically well-connected. There are many programs at HUD that could have been examined. Congress chose in its investigations to examine a few. The principal ones are summarized here.

This presentation is not meant as an exhaustive description of the scandals. Rather, it is a sampling of some of the more flagrant improprieties between 1980-1988, based on congressional testimony, media inquiries, and HUD Inspector General investigations. These scandals demonstrate many of the design and implementation flaws and institutional weaknesses at HUD that shaped the subcommittee investigation.

A more thorough discussion of the scandals themselves is expected in the forthcoming report of the House Government Operations Committee, Subcommittee on Employment and Housing.

This chapter describes the environment and the characters that made up the HUD story. First, the context of the Mod Rehab story in particular is that of a program that the Secretary did not want. This simple fact can go a long ways towards explaining the patterns of mismanagement, abuse, and favoritism that made up the HUD culture during the Pierce years. Second, there were two types of characters involved. Those on the "inside" such as Secretary Pierce and the other political appointees acting from within the agency. And those on the "outside" such as the lobbyists and developers acting from outside the agency. HUD's revolving door and the pervasive influence peddling often blurred the distinction between who was "inside" and who was "outside."

Not to be forgotten in this story are the victims -- the poor who were denied housing unnecessarily because of dubious funding allocations, and the taxpayers who must pay for the costly abuse to the programs. The revelations might make for a good story if not for the thousands of low income families who were denied adequate housing due to the waste and mismanagement.

Since three prominent figures -- Samuel Pierce, Lance Wilson, and Debbie Dean -- either refused to testify or refused to return once additional questions arose, some of the story remains open to speculation.

I. Section 8 Moderate Rehabilitation Program

A. Background and Evolution

> HUD's funding allocation process was undocumented, contrary to pertinent regulations, and left a widespread perception that Mod Rehab was a Headquarters-driven program favoring certain PHAs, owners, developers, and consultants.[2]
>
> Paul Adams

Enacted in 1978, the Moderate Rehabilitation Program was intended to upgrade housing that does not meet HUD's minimum quality standards but could become decent low-income housing with relatively minor improvements. The program was originally designed to provide modest financial assistance for owners of buildings with relatively few units to make repairs costing $1000 to $6500 per unit. In return, these owners guarantee to set aside a certain number of units for low-income tenants.[3]

Under the program, low-income tenants pay 30 percent of their income for rent each month and HUD pays the landlord the difference between that amount and the full fair market rent (FMR) which is set by HUD. Local Public Housing Authorities (PHAs) that HUD selects to participate in the program are notified that funding is available. The PHA then advertises for applications from developers for competitive bids.[4]

Subsidy payments go to states or local housing authorities, which then distribute them to developers. The owners receive their funding through monthly subsidies for 15 years beginning after the rehabilitation is completed and tenants have moved in. Once developers receive the allocation, which guarantees an income for 15 years, they can borrow money to finance the project.[5]

The administration of the Mod Rehab program went through at least three stages: an initial stage when funds were allocated by regional offices under the "fair-share" system to all states based on each state's housing needs; a free-wheeling stage following the suspension of "fair-share" allocations in 1984; and a final stage after an allocation committee was established in January 1987.

Reduced funding and the removal of the fair share allocation process resulted in only 204 of the 3,000 PHAs receiving funding between 1984-1988.

Ten states received 51% of all Mod Rehab program units. The fair share percentage would have been 16%.[6] Fifteen PHAs received 4 or more allocations each during the period under review.[7]

This chapter considers some of the reasons that the allocation of funding went to such a limited and select number of recipients.

B. Mismanagement

> (The Mod Rehab program) was set up and designed to be a political program ... I would have to say we ran it in a political manner.[8]
>
> Deborah Gore Dean

Secretary Pierce tried to terminate the Mod Rehab program because he felt it was an inefficient and costly production program.[9] Although he was not immediately successful, the program's management deteriorated until it became the program he professed it to be.

The process by which PHAs received Mod Rehab program funds was undocumented and ignored existing standards and regulations.[10] Once Fair Share was eliminated, existing regulations were no longer applied. When asked why no new regulations were enacted, Secretary Pierce indicated that they were not necessary.[11] The statutory change which waived Fair Share did not require alternative regulations. The absence of Fair Share and any alternative regulations put hundreds of millions of dollars at the discretion of the Secretary and his senior staff. Not coincidentally, the IG testified that with the waiver of the fair share provisions, "there was no accountability," and that funding decisions became discretionary.[12]

Pierce's view that the Mod Rehab funds were completely at his discretion was apparently based upon an alleged oral opinion to that effcet by his General Counsel John Knapp. While much confusion over whether this opinion was ever given, it seems to have played a vital role in the subsequent abuse of the program.[13]

Favored developers and consultants got key information about funding availability before local public housing authority officials.[14] The Director of Housing for New Jersey testified that a group of developers and their consultants requested him to apply for MRP funds for a project in Seabrook, N.J., in late 1986.[15] The owners did not purchase the development that was to be rehabilitated until April, 1987. This was two weeks prior to state officials learning that they had been awarded the HUD funding.[16] A partner in the project testified that conversations between his firm and Pierce's executive assistant, Debbie Dean, led him to believe that the project would likely get funded.[17]

Lack of adequate monitoring and political motivations caused significant waste to the Department to go unnoticed, ignored or minimized. For instance, according to a number of news articles[18], the Atlanta regional office reported that a partnership which included the deputy chief counsel to the 1980 Reagan-Bush campaign had overcharged the government by $593,782. Included in these charges were ineligible or unsupported development costs that exceeded necessary and reasonable amounts.[19] However, the Deputy Assistant Secretary at the time, R. Hunter Cushing, decided that the partnership only had to pay $88,772. A recent audit suggests a figure of $757,677.

Warnings and objections from HUD career staff were ignored or overridden. Silvio DeBartolomeis, testified that career staff became only minimally involved in the Mod Rehab program selection process.[20] However, former Secretary of the Interior, James Watt, who acted as a consultant on a number of HUD projects, used as justification for dealing directly with Pierce the conclusion that the problem with the program was that political appointees were afraid to make a decision without career staff.[21]

The Department provided little, if any, training and technical assistance to field staff. Adams testified that HUD and PHA staff were ill-equipped to compute contract rents properly.[22] This contributed to excessive housing assistance payments totalling approximately $58.8 million during the 15 year contract terms for projects at 20 PHAs reviewed.[23]

Deep funding cuts reduced HUD's ability to monitor its programs and to retain competent personnel. Budget authority dropped from $33.4 billion in fiscal year 1981 to $14.7 billion in fiscal year 1987, a cut of over 50%.[24] Staff was slashed from 15,122 in 1981 to 11,178 in 1986, a drop of nearly 30%.[25]

Among the positions that were abolished was the entire office of organization management and information, which monitored the work of HUD field offices. As a result, oversight was being cut at the same time that HUD was granting excessive subsidies. In projects which the IG reviewed, this waste totalled about $50 million. Extrapolated nationwide, excessive subsidies were projected by the Inspector General to be as much as $413 million.[26] The Seabrook project described earlier, for example, included $31 million in rent subsidies over 15 years and over $11 million in low income housing tax credits over 10 years, yet the total rehabilitation costs were $11 million. At best, the unfortunate effect of this waste was not only that projects were over-funded, but more necessary projects could have been funded.

Mismanagement allowed many programs at HUD to be abused. But the mismanagement of the Mod Rehab program was itself caused, in large part, by Pierce's own rejection of the program.

C. Secretary Pierce

> ...[P]erhaps we should have watched the program closer than we did....[27]
>
> Samuel Pierce

In 1980, Samuel Pierce came to the Reagan Administration as a highly respected lawyer, criminal court judge, and former Treasury official. He was the only senior cabinet official to remain in the same position throughout the Reagan Administration. He was also one of the least outspoken, earning the title "Silent Sam."[28]

In Pierce's confirmation hearings he promised to implement a management style that would make HUD more efficient with fewer scarce resources.[29] One of the programs that Pierce came to disapprove of the most was the Mod Rehab program. He stated, "I, along with a number of others, considered the MRP to be an economically inefficient and ineffective program, and during my last six years as Secretary of Housing and Urban Development, we tried to terminate it."[30] Ironically, it was not until these very six years that the Mod Rehab program experienced the extent of mismanagement and favoritism that the Inspector General first reported.

The 1980s saw an overwhelming political bias towards favored Republican consultants and developers. While a somewhat similar bias towards Democrats existed in the Carter Administration, the level and type of abuse during the Pierce Administration was extraordinary.[31] According to Anthony Downs, senior fellow at the Brookings Institute, "The big difference is that the people who were in HUD under the Carter Administration had some interest in the subject and were interested in serving the constituencies the department worked with -- cities, poor people and the housing industry."[32]

At the end of Pierce's eight year tenure at HUD, internal audits, media inquiries and congressional investigations revealed one scandal after another at the department. Pierce's successor, Jack Kemp, described the problems at the Department that he took over as a "poison in the system."[33]

None of the major investigations have revealed that Secretary Pierce benefitted financially from the fraud and abuse at the Department. By his own testimony, Pierce was detached from much of the details at HUD.[34] At a minimum, though, it appears that his "hands-off" management style helped create the opportunity for scandal.

The Secretary did intervene on a few select projects, though he testified that he would only instruct staff members to give "careful consideration" to a particular application.[35] Silvio DeBartolomeis, the former General Deputy

Assistant Secretary, testified that he did not interpret this to mean that such a project must be funded.[36]

But other witnesses and documents contradict Pierce's testimony by referring to instances that Pierce gave some people special consideration. Thomas Demery, the former Assistant Secretary for housing, described instances where Pierce took an active role in funding particular projects. He reported that Dean would arrive at meetings with lists of projects that she and Pierce wanted to fund.[37]

During three days of testimony, Dubois Gilliam, the former Deputy Assistant Secretary for Program Policy Development and Evaluation, described how Pierce directed HUD program funds to projects sponsored by his friends or well connected members of the Republican party.[38] In so doing, Gilliam contradicted at least three sworn statements by Pierce that he had not directly instructed the funding of any projects.[39]

In fact, the former Secretary even promised to direct 250 Mod Rehab units to Gilliam prior to leaving the Department. Gilliam stated,

> I told Deborah (Dean) about my conversation with the Secretary and that as a part of my leaving I needed to get 400 units of Section 8 Mod Rehab, and I wanted to have that arrangement before I left. I told her I wanted her to talk to the Secretary about it because I did not want to have a direct conversation with him about those units because I thought there might be some legal problems.
>
> So Deborah went and spoke to the Secretary, the way she explained it to me. She came back and told me I had 250 units. I couldn't have 400 units because I was being greedy.[40]

This was viewed as a Golden Parachute deal[41] that Gilliam estimated was worth millions of dollars.[42]

Other evidence suggests that Pierce repeatedly became involved in the funding of projects involving friends, political cronies, and former associates. For example, the former Secretary promised his personal assistance to old friend and jazz musician Lionel Hampton on a housing project in Atlanta. Upon hearing about some environmental and technical problems Hampton was having on the project, Pierce wrote to him with assurances "to offer you any assistance possible."[43]

Earlier in his Atlanta project, Hampton wrote to Pierce that another developer in the project was a "fellow eagle," which refers to contributors to the

Republican National Committee who donate $10,000 or more a year to the party. In particular, Hampton wrote that "I hope that I can count on your support as I have been able to in the past....I look forward to personally discussing this venture with you."[44]

In addition, Pierce ignored staff recommendations to refuse funding a project supported by a number of his friends and colleagues, including a former associate at Pierce's law firm and former Mayor of Durham, Charles B. Markam. According to Shirley Wiseman, the former Federal Housing Commissioner, Pierce approached her regarding the funding of the 151 unit Durham Hosiery Mill project.[45] Wiseman refused to approve the project, noting strong opposition from career staff who questioned its proximity to railroad tracks, multiple subsidies,[46] excessive policy waivers, chemical waste, and high cost.[47]

Wiseman's successor, Janet Hale, was also approached by Dean who told her that Pierce wanted the project funded. Hale received a funding approval document that already had Pierce's signature on it.[48] Hale stated, "To my knowledge, there was no one else (besides Dean and Pierce) in support of the project within the building."[49]

After the project was approved, the developers did in fact seek waivers from HUD requirements because the project was too close to railroad tracks, it required rent that was 132% above ordinary rent levels, and occupancy levels were inadequate.[50]

D. Political Appointees

> Secretary Pierce, in my opinion, was not given a fair chance on naming his own sub-Cabinet members and that resulted in disloyalty, and that resulted in a poor management of the agency at that time.[51]
>
> Dubois Gilliam

Unlike most cabinet officials, Pierce was unable to bring in his own team of professionals.[52] Instead, the White House provided him a number of appointees with dubious qualifications and motivations to run critical housing programs.[53] Pierce's former aides described how the Reagan Administration used HUD as a plum to reward jobs to political allies.[54]

Joseph Strauss, testified that he managed to get appointed as one of Pierce's top aides because of connections he made during Ronald Reagan's presidential campaign in 1980. He was hired the following year at the age of 24 with no housing experience and became Special Assistant to Pierce.[55]

As Gilliam described the situation, "Samuel Pierce got loaded up on him a group of Young Turks who were very political and on a (White House personnel) must-hire list, and we had no housing skills whatsoever."[56] Gilliam also testified that he believed that the Office of Presidential Personnel "compromised" when choosing among candidates for top HUD political positions.[57]

No appointee has received more attention -- both during and after her tenure at HUD -- than Pierce's Executive Assistant and top aide, Deborah Gore Dean. Prior to her work at HUD, Dean had published a local magazine, worked as a bartender, hostess and manager at her family's businesses for nine years, and worked at the Department of Energy where she served as a Special Assistant in the Public Affairs division.[58]

After being introduced to Lance Wilson, former Executive Assistant to Pierce, she was made Special Assistant in charge of running Pierce's correspondence office. Two years later in 1984, she replaced Wilson as the Secretary's Executive Assistant responsible for serving on behalf of Pierce on several decision making panels.

In 1987, Pierce attempted to nominate Dean for Assistant Secretary for Community Planning and Development. But the Senate's concern over her lack of housing experience and questionable activities at HUD helped lead to its refusal to confirm her.[59] For instance, the Senate Committee on Banking, Housing, and Urban Affairs questioned her about charges that had been filed with the IG that she had abused her position. Included in the charges was that she had required subordinates to perform personal services for her during office hours such as cleaning and painting her apartment,[60] and that she had improperly used a department-issued credit card for personal purchases.[61]

Ironically, Dean served as Pierce's representative on the Secretary's Committee on Waste, Fraud and Mismanagement.[62]

Since the former Secretary sometimes disagreed with the White House appointee selections, and because Pierce did not have the ability to appoint personnel that he may have wanted, many of the top positions became a musical chair or went unfilled. For example, the position of Assistant Secretary for Housing, which administers the essential programs at the Department, changed ten times in eight years.[63] The position of Under-Secretary was vacant for 16 months from 1986-1987 while Pierce attempted unsuccessfully to appoint his own choice for the position.

The numerous top positions that went unfilled appear to have blurred lines of authority. As a result, some aides such as Strauss, Demery, Gilliam, and Dean were successful at wielding tremendous influence as they filled the leadership void.

During her failed confirmation hearing, Dean testified that she had, "never given or approved or pushed or coerced anyone to help any developer [win a grant in the Mod Rehab program]."[64] Since then, however, witnesses and internal documents have directly contradicted this sworn statement.

Silvio DeBartolomeis understood Dean to be the final decision maker, and that she made her decisions with the approval of the Secretary.[65] Demery also believed that she "functioned as the de facto Secretary," and that Pierce made it clear that Dean spoke on his behalf.[66]

Dean's files were filled with "Dear Debbie" notes from developers, consultants, and officials of the Republican party who contacted Dean about specific projects. For example, the political director of the National Republican Senatorial Committee, Richard Shelby, sent Dean a hand written note thanking her for "all the time and effort which you have necessarily had to expend on my behalf" and offering to "reciprocate...at some time in the future."[67]

Former HUD official Philip Abrams, sent handwritten "Dear Debbie" notes to Dean requesting support for projects in Nevada and Oklahoma. Both projects received funding.[68]

The correspondence went the other way, as well. For example, in 1985 Dean wrote a letter to Abrams and stated, "As always, if there is anything that I can do for you and Roz -- just whistle."[69]

The high turnover and vacant positions were only two of the reasons that some political appointees at HUD were so influential and the center of attention. As the Department's monitoring ability was reduced, efforts to persuade individual HUD appointees were particularly effective. As the numerous "Dear Debbie" notes suggest, Dean frequently served as the contact person for developers interested in doing business with HUD.

The repeal of certain statutory requirements such as the Fair Share allocation also enabled officials such as Dean and Demery to direct much of the individual funding decisions.

After Fair Share was eliminated, Pierce established a committee to review funding requests. The committee consisted of three political appointees: the Assistant Secretary for Housing, the Under-Secretary, and the Executive Assistant to the Secretary. Later, the Executive Assistant was replaced by the General Counsel. There was no career staff on the committee. Pierce retained final approval.

The Assistant Secretary's position was vacant for a while, and the acting Assistant Secretary, Silvio DeBartolomeis, indicated that he never attended a meeting while in that position.[70] The Under-Secretary's position was also vacant for some time. As a result, the only consistent person on the committee was Dean who had no housing program experience.[71] In addition, there seems to have been much confusion about the committee by those who were supposed to have served on it. Neither DeBartolomeis nor Acting Assistant Secretaries of Housing Shirley Wiseman or Janet Hale had even heard of the committee!

The former General Counsel, J. Michael Dorsey, described how the committee which Pierce organized in place of Fair Share met on one occasion in March, 1987, for 30 minutes. Dean, Demery, and he decided the funding for about 15 projects during that brief time. The merits of the individual projects were not discussed in any detail, if at all.[72] And there is no evidence to suggest that any projects on the list reviewed by the committee were ever turned down for funding.[73]

Dubois Gilliam described the process by which committee members brought lists of projects to the meeting for funding, stating "If you weren't sitting at the table that day you didn't eat, simple as that."[74]

Final decisions were based not on specific rules or regulations, but rather on the judgments of a small handful of appointees with limited background in housing policy. With no regulations, the only people who knew how to get MRP funding through the agency were a handful of insiders who had previously worked at HUD or who were politically connected.

E. HUD's Revolving Door

> I perceived during my last year or so at HUD that there was a niche in the private sector for an individual who had an understanding of HUD programs.[75]
>
> Joseph Strauss

The Inspector General revealed in his report that a number of former Reagan appointees at HUD became enormously successful consultants, developers, lenders and owners of HUD assisted housing once they left the Department. They included a former:

Under Secretary -- owner/developer of 6 projects,
Asst Secy for Housing -- owner/developer of 7 projects,
Exec Asst to Secy -- owner/developer of 6 projects,
Spec Asst to Secy -- consultant on 13 projects,
Deputy Asst Secy for Housing -- consultant on 3 projects,
Spec Asst to Asst Secy for Housing -- consultant 2 projects,
Deputy General Counsel -- consultant on 3 projects, and
various regional officials -- over 30 projects.

Adams noted that former HUD officials participated in various roles in at least 55 MRP projects.[76] One or more former HUD officials was involved as an officer, consultant, or mortgage broker in 23 projects located in Oklahoma, Colorado, Wyoming, and Nevada.[77]

One organization alone, informally referred to by Adams as the Winn Group, included Phillip Winn, former Assistant Secretary for Housing; Philip Abrams, former Under-Secretary; Joseph M. Queenan, former Director of Housing Development in the Denver office; and Lance Wilson, former Executive Assistant.

Of the projects reviewed by the Inspector General in his audit of the Mod Rehab program, between 1984-1988, this group won $133.6 million for subsidized rents in 1,347 housing units, or about 5% of the units available during this period. The group received another $29 million in tax credits.[78] Of the seven projects reviewed for which the group applied, six were funded.[79]

One former Special Assistant to Pierce, Joseph Strauss, formed a consulting firm specializing in housing programs shortly after leaving HUD.[80] The firm earned over $1.7 million in fees from developers interested in his connections at, and expertise concerning, the Department.

Michael Karem, who was the Deputy Assistant Secretary for Multi-Family Housing from 1981 to 1982, shared this extraordinary ability to receive HUD assistance after leaving the Department. One witness described six projects in which Karem received over $12.5 million in UDAG assistance.[81]

Lance Wilson, who preceded Dean as Executive Assistant, made millions of dollars from HUD projects both as an investor and as a consultant. He was a one-third partner in at least five projects that generated over $20 million in tax credits over 10 years, earning Wilson about $3 million minus expenses.[82] HUD files suggest that he regularly communicated with senior HUD officials such as Dean and Demery.[83]

It is not unusual for individuals to leave the public sector and earn more money in private business by working in the same subject area. However, ethical issues arise where former officials get special consideration for dwindling resources. One of the inquiries that the IG focused on in his investigation was the perception of favoritism and abuse. Such a perception alone likely discouraged many needed projects simply because former insiders were not involved.

F. The Consultants and Political Influence Peddling

> The technical term for what we do -- and law firms, associations, and professional groups do is lobby....For the purposes of today, I will stipulate that, in a narrow sense, some people may term it influence-peddling.[84]
>
> Paul Manafort

The two geographic areas that received the most disproportionate share of funding after Fair Share was terminated -- Florida and Puerto Rico -- also had the highest number of projects funded with the help of consultants. And 45 of the 51 projects involving consultants were in states that received a disproportionately high share of mod rehab funding.[85]

The extensive use of lobbyists reflects the political nature of the Mod Rehab program. One basic issue that has been raised is to what extent the program was political by its design, or by the individuals running the Department. On the one hand, Dean described the Mod Rehab program as "set up and designed to be a political program," and that "we ran it in a political manner."[86]

On the other hand, the former General Deputy Assistant Secretary, Silvio DeBartolomeis, disagreed that the Mod Rehab program was designed to be political. However, he suggested that it evolved into a political program and became subject to influence peddling when funding was cut.[87]

Consultant fees went to a number of major Republican figures. Some were former HUD officials. Others had little housing knowledge but were active in the Republican party. In 270 projects between 1984 and 1988, 20 prominent Republicans and former HUD officials were paid in excess of $5.7 million for lobbying services on 51 projects.[88]

HUD records reveal that a number of leading Republicans contacted Debbie Dean for help in getting projects funded including: former Energy Secretary under Reagan, James Edwards; Lieutenant Governor William Scranton of Pennsylvania; former chairman of the Florida Republican party, William Taylor; and former chairman of the Utah Republican party, Larry Lunt.[89]

The prominent lobbying firm of Black, Manafort, Stone & Kelly had a number of clients involved in federal housing programs. The firm's principals include Paul Manafort, a senior campaign strategist for President Bush and political director of the 1988 Republican National Convention; Nicholas Panuzio, an adviser on urban affairs in the 1980 Republican Presidential campaign; Charles Black, a major GOP strategist who managed the 1988 presidential campaign of HUD Secretary Kemp; and Lee Atwater, who was associated with the firm before joining the Bush presidential campaign and later became the chairman of the Republican National Committee.

William Taylor, a Republican National Committee state chairman from Florida, worked on a number of projects including one for which he earned $415,000 in cash and property. He estimated that he worked 100 hours on this project.[90] Taylor testified that he saw nothing wrong with trading political connections for private gain. In fact, he repeatedly wrote to Pierce and Dean on Republican National Committee letterhead, later stating that "I'd like for Mr. Pierce to know that Bill Taylor is the national committeeman from Florida."[91]

Former Secretary of the Interior under Reagan, James Watt, was the consultant who first received attention due to the IG's report. Judith Siegel, a developer, hired Watt not for his expertise in housing but to "drive the Federal bureaucracy when it needed to be driven."[92] She late reaffirmed that Watt could "get HUD to pay attention to this application, an ability I didn't possess....Mr. Watt could get phone calls returned. Mine would be ignored."[93]

Similarly, Fred Bush, who had previously served as the Deputy Chief of Staff for Vice President Bush and the President Bush's chief fund raiser, testified that he "did not bring very much" in terms of housing knowledge and that his role was to provide introductions to clients seeking to meet policymakers.[94] A description of his firm that was sent to HUD shows that Bush and Associates heavily promoted ties to the White House and most Federal agencies.[95]

Despite this general lack of familiarity with the housing programs, many consultants received astonishing sums -- typically $1000-1500 per unit -- to influence the allocation of moderate rehab funding because of their access to top HUD officials. For example, the Manafort firm earned $326,000 in fees for its work on a project in Seabrook, New Jersey. Manafort testified that this worked out to about $1000 per hour of work,[96] an unusually large rate even for the most influential Washington lobbyists.[97]

Watt's work on the Maryland project for which he earned $300,000 involved eight phone calls to the Department and a 30 minute meeting with Pierce.[98] After HUD awarded the funds for the project, Watt wrote a letter to Pierce stating "Thanks! You are a man of your word."[99]

James Watt received perhaps the most attention by the media due to his senior position in the Reagan Administration. However, he was by no means alone nor the most successful. Joseph Strauss, a former Special Assistant to the Secretary, received over $1.7 million in such fees. Richard Shelby, a former White House assistant in the personnel office received $442,000. Fred Bush received $215,000. Michael Karen, former Deputy Assistant Secretary for

Multifamily Housing received $360,000. Former Senator Ed Brooke received $183,000.[100] Former Attorney General John Mitchell received $75,000.[101]

Favored developers and consultants did not gain influence solely through political contacts. Some of them provided significant contributions to charities supported by senior HUD officials. For example, before becoming Assistant Secretary of Housing from 1986-1989, Thomas Demery had served as a director of FOOD for Africa, a non-profit charity, between 1985 and 1986, and appeared at several fund raisers for the organization while at the Department. Recipients of rehabilitation funds contributed nearly $300,000 to FOOD for Africa.[102]

Other HUD officials were also involved in charities that received contributions from interests they were responsible for regulating. High level officials in the New York regional office regularly solicited developers, architects, etc. for donations for charities, causes, and parties.[103] The general impression of the contributors and the non-contributors was that these donations were part of doing business with the regional office.[104]

It is a violation of the Federal ethics code to use "public office or official title for private gain."[105] In some instances, this includes the solicitation of contributions to particular charities.[106]

G. The Developers

> [D]o I think the selection process was good public policy? No. Do I think a more competitive process would have been better public policy? Of course. But the system was there. I followed the rules and I developed high quality, low income housing. Developers must not be blamed for the system they neither created nor administered.[107]
>
> Judith Siegel

The size of the consultants' fees and the vagueness of their services are the clearest evidence that the program was exploited. The Mod Rehab program, if properly administered, would provide only modest incentives to upgrade a property. There should be no capacity or incentive to pay anyone large fees to get an allocation.

Developers such as Judith Siegel argued that the fees were paid from developers' profits. However, that some developers reaped enormous profits through the layering of benefits. This practice made the projects sufficiently lucrative to justify the use of persons having political and personal ties to HUD officials.

Some developers parlayed the program into very lucrative deals by using additional incentives, such as tax exempt bond financing, syndication of low-income housing tax credits, and financing under the HUD co-insurance program. The low income tax credit program allowed developers, who were already receiving sizable subsidies, to increase their profits by selling the credits to syndicators. When used in combination with other funding sources, the GAO testified that developers are able to accumulate "cash proceeds that greatly exceeded costs associated with acquiring and rehabilitating the properties."[108]

The return on investment could be enormous. The IG estimates that the Winn Group was able to get $2 million up front from one project in Denver by offsetting the costs of land acquisition, development costs and other fees with the proceeds from syndication of tax credits. In another project in Nevada, the group put $12,000-15,000 at risk on a 160 unit project for which there was nearly $26 million in public funds at stake.[109]

Paul Manafort, a part owner of the 326-unit project in Seabrook, New Jersey, helped secure $31,163,000 in rent subsidies over 15 years for refurbishing and maintaining the property.[110] In addition, the developers earned $921,500 in syndication proceeds after selling interests in the partnership and state allocated tax credits less than a year after acquiring the project for $4.4 million.[111]

And the Durham project mentioned earlier included a variety of different federal programs: a $2.3 million development grant, $11.5 million in rent subsidies over 15 years, federally backed insurance to cover potential losses, state allocated tax credits, as well as other tax credits relating to historic landmark preservation.[112]

The IG also found that well-connected developers distorted the program so they could generate huge profits through substantial rehabilitation on large-scale projects.[113]

In some cases, the developers appear to have targeted oil patch markets where property values had collapsed but HUD's Fair Market Rents -- upon which developers' guaranteed rent rolls are based -- had not yet been lowered to reflect actual market conditions.[114]

In other cases, developers got excessively high FHA financing through private co-insurers.[115]

Developers exploited the process as well as the program. The Mod Rehab application procedure originally required PHAs to request funding for units for which developers would then competitively bid. This system helped assure that requests originated from local officials to satisfy local needs, and that costs of the projects were kept to a minimum. During the Pierce years, this process changed so that developers themselves, or lobbyists they hired, obtained approval from HUD. The PHA awarded the project to that developer who was able to take advantage of the inside information and had access to key HUD officials.

This often led to perverse consequences. For example, a lobbyist and part owner in the 326-unit Seabrook project mentioned above, gave the following chronology of events.[116] He met with HUD officials in Washington, D.C., on November 14, 1986. He then met with the New Jersey State Housing Authority on November 19, 1986 to request that they submit a funding application for 326 mod rehab units, exactly the number of units in the complex. The housing authority submitted an application the next day which was funded on June 1, 1987.

The senior state housing official, who is responsible for applying for funds on a state wide basis, was asked by an employee of the lobbying firm to make copies of the application available to Pierce and Dean. He admitted that the application for funds was for the Seabrook project specifically and that the Mayor of the local community was never notified. The developer further admitted that no other project could compete for the particular earmarking for which he had requested the housing authority to submit an MRP application.[117]

In fact, the advertisement was worded so narrowly that only one contractor -- the partnership that originally approached HUD in Washington -- submitted a bid.[118]

Local officials were not consulted about the need for the project, which was considered too big, unnecessary, and expensive.[119] One official testified that he was led to believe HUD approval had already been given by the time he learned about the project, and that there was nothing he could do about it.[120]

All of this testimony suggests a reversal of procedures. Rather than allow housing authorities to award the funds competitively, fifty-nine out of sixty-nine projects reviewed by the HUD IG indicated project-specific selections by headquarters. In 19 projects, the developer approached the PHA and got the funding. In 25 projects, the developers paid consultants, including former HUD officials, to lobby HUD.[121]

Joseph Strauss, former Special Assistant to the Secretary who became a consultant on at least 13 Mod Rehab program projects, admitted that the Mod Rehab program was a developer driven program. Developers who had the contacts would get their projects funded.[122]

II. Other Discretionary Programs

The Mod Rehab program was, apparently, not the only program which was corrupted by favoritism, fraud and mismanagement. During his three days of testimony before the House Subcommittee on Employment and Housing, former Deputy Assistant Secretary Dubois Gilliam testified under a grant of immunity to similar abuses in the selection process of the Urban Development Action Grant (UDAG) program and the programs under the Secretary's Discretionary Fund (Technical Assistance and Special Projects).[123]

The UDAG program provides funding to cities and urban counties experiencing severe economic distress to stimulate economic development. The local governments use the funds to make loans to private developers for commercial, residential, and industrial projects. UDAG was another program, like the Mod Rehab program, which Pierce attempted to kill during his term. Funding for the program was reduced from $675 million in 1981 to $216 million in 1988. Even though the program was designed to rank projects according to well-established criteria, Gilliam testified that the funding process was politicized under Pierce.[124]

Pierce personally instructed Gilliam to fund projects, sometimes before the project's application had been submitted to HUD. One situation involved UDAG assistance to the Hampton Institute in Virginia on which Pierce was serving on the board of trustees.[125]

Gilliam also mentioned an occasion in which Pierce directed that an application be killed because of the interest of Congressman Henry Gonzalez (D. Texas).[126]

A number of projects which were awarded solely on the basis of political and personal connections. During Gilliam's tenure, applications for UDAG grants were ranked according to merit, but were also accompanied by the name of any politically connected individuals backing each proposed project. Gilliam manipulated the dollar amount of each funding round to ensure that prospective projects backed by politically connected individuals would receive money, despite the fact that these project applications may have received low merit rankings.

Gilliam testified regarding the funding of several projects because of the involvement of Lance Wilson, even though in one instance Pierce was opposed because one of the developers was a "crook."[127]

Gilliam also testified to the transfer of a career employee to Gilliam's staff, at the Secretary's instruction, who Gilliam believed might inform the Inspector General of fraud in the funding of a particular project under the UDAG program.[128]

Another program, the Technical Assistance Grant Program, provides assistance to states and local governments in planning, developing and administering funds from the Community Development Block Grant Program. The Technical Assistance Grant Program is funded out of the Secretary's Discretionary Fund.

Gilliam testified that the Pierce Administration used the program as a political slush fund. In fact, of the 200 projects funded out of the technical assistance program during Gilliam's tenure, only one was not political in nature.[129]

Funding decisions were generally made at meetings attended by Gilliam, Pierce, and Dean. At such meetings, Gilliam would go down the list of applications which would disclose the name of the contractor and a description of the proposal, and indicate the political connections of the contractor or sponsor. One example was a $296,380 grant to Fred Bush, a consultant and major Republican fundraiser, who got Dean to serve as his "pony" and ride the request through.[130]

Gilliam testified to numerous instances of funding being provided under this program to applicants based upon their political connections or friendship to Pierce, even though these applicants often possessed no ability to carry out the duties being funded.[131]

For example, Fred Bush lobbied top HUD officials regarding a $253,000 technical assistance grant for a development project in San Juan, Puerto Rico.[132] An internal staff urged that the award be denied because, in part, Bush's company lacked the relevant experience.[133] Nevertheless, HUD funded the project the next year.[134] An IG report said that the proposal, "generally was not based on historical cost data or projections of reasonable costs," but was instead "based on the amount of funds expected to be available for award." [135]

In another instance, Pierce directed Gilliam to help a friend receive $350,000 in program funds even though the applicable city did not request the funds. In fact, remarkably, Gilliam had to travel to Camden, New Jersey and convince a doubting mayor that HUD would provide funds to the organization associated with Pierce's friend for the benefit of the city.[136]

The Inspector General had audited the Technical Assistance Program in 1986 and severely criticized the selection of projects and the effectiveness of selected projects. HUD management ignored these criticisms. Gilliam told the IG at the time that, "this is the Secretary's discretionary fund and you don't have any business in directing us how to spend them."[137]

III. Co-insurance

Among the HUD programs that developers used in conjunction with Mod Rehab, one of the most wasteful in terms of dollars lost was the co-insurance program.

The Section 223(f) co-insurance program for multifamily housing was established at HUD in 1983 at a time when HUD sought to privatize its insurance program. A representative of the Mortgage Bankers Association (MBA) testified that co-insurance was also the result of staff cutbacks that caused delays in processing of loans at HUD which threatened the viability of projects.[138]

Prior to 1983, HUD provided full insurance for multifamily housing, performed its own appraisals, and supervised loan repayments. Under the co-insurance program, lenders performed all functions relating to mortgage approval independent of HUD and were liable for approximately 20 percent of any loss. In exchange, lenders received a percentage of the mortgage amount as a fee.

Mortgage companies would make loans to projects and then sell securities to the public through the Government National Mortgage Association (GNMA). These instruments are secured by the proceeds of the loan. The mortgage companies collect payments from the owners and pass them on to purchasers of the securities.

In a 1985 audit, the IG first discovered abuse of the program stemming from inflated mortgages.[139] In addition, the IG found that inappropriate lender underwriting practices had caused inflated mortgages for the 8 projects reviewed and that the mortgages were excessive by $36 million.[140] The IG testified that HUD found this assessment to be "unfair and unjustified" since the lender shared in any loss and there had been no foreclosures. Further, "housing officials stated that the controls we (the IG office) suggested were too strict and would impair the co-insurance concept."[141]

An IG audit 18 months later concluded that the lenders were not aggressively servicing loans, there was no review of appraisals, only periodic monitoring of the program by HUD, and 13 percent of the 815 co-insurance loans had already defaulted. Despite this new evidence, HUD again stated that the IG was overstating the problem.[142] HUD agreed to improve controls but disagreed with recommendations regarding project design and enforcement. The MBA had also sent a 1986 correspondence to Pierce warning him about unsound underwriting practices and lack of management oversight by HUD.[143]

Although, defaults and associated losses in the program stem primarily from the activities of a small number of lenders, nearly $700 million in mortgages are in default.[144] FHA estimates the potential loss from the program to be about $960 million.[145] One insurer alone, DRG Funding Corporation, had a default rate of 29% which accounted for nearly 77% of all defaulted loans in the program. By the time HUD belatedly seized control of its $1.1 billion portfolio, DRG was in default in over 100 mortgages totaling $671 million.[146]

The IG found that another major co-insuring lender, Benton Mortgage Company, did not follow "prudent underwriting practices."[147] The company had overvalued all 14 projects under review by an average of 29% and at a cost of $22 million.[148] These practices "resulted in material misrepresentation of mortgage amounts and rents."[149] Since all of these mortgages are federally insured, the lenders had little incentive to underwrite loans prudently. Like the savings and loan debacle, the taxpayer would cover the loss.

Among a handful of co-insurance lenders, the IG disclosed consistent patterns of inflated appraisals to justify mortgages substantially greater than actual property values, unrealistic occupancy projections, and excessive rent income projections. In one case, the mortgage company, DRG Funding, appraised a 1,818 unit apartment complex at $60 million and underwrote a $47 million loan for financing. However, only 6% of the units were occupied with no indication that the project, located in economically depressed Houston, would turn around. The central office directed the regional Administrator to insure the project over objections from his staff objections which valued the property at only $13 million. The loan was in default a year later, and the property was sold for a reported $8.7 million.[150]

One apparent reason that staff objections were overruled was the role played by former HUD Secretary Carla Hills. Like the Mod Rehab program, some co-insurance lenders hired consultants, such as Hills, to lobby HUD. Hills, the current U.S. Trade Representative and former Secretary of HUD under the Ford Administration, met with Pierce on behalf of DRG Funding Corp. She had already failed to convince other HUD officials to ease restrictions on her client which was the largest private mortgage lender involved in the HUD Co-insurance program.[151] Pierce lifted the restrictions a few weeks after meeting with Hills.

Although no one has questioned Hills' expertise in housing or the integrity of her work, DRG now has over $530 million in defaulted mortgages because of improper loan underwriting.

Another former senior HUD official that DRG hired was Washington lawyer Lynda Murphy. Murphy, who at one time was a close friend of Debbie Dean, helped draft a letter for Dean's signature that allowed DRG to modify the terms of a $47 million mortgage that later defaulted. The property was sold for $8.9 million. Murphy admitted that it was not unusual for her to see such documents prior to distribution.[152]

One reason that relatively few lenders controlled so much of the market -- and were responsible for so much of the losses -- was because many prudent lenders could not compete against companies that offered loans based on inflated mortgages. Developers would simply go lender shopping to find the highest loan and then seek an appraisal to justify the inflated value.[153]

The failure of the program can be traced to a number of systemic weaknesses. Adams testified that one of the fundamental problems with the program was that the lender's fee was tied to the amount of the loan, thereby creating an incentive to inflate. Although most losses are due to mismanagement more than outright fraud, investigators in the IG's office suggest that developers and mortgage lenders conspired to "goldplate" some projects which led to overvalued and overinsured projects.[154]

One regional administrator for HUD reported that Co-insuring lenders inflated income streams, lowered expenses, and came in with unrealistically high value and mortgage amounts. He added that the Achilles' heel in the process was that field offices could not be involved in the underwriting, and the central office would only monitor after the fact.[155]

These underwriting practices had at least two adverse consequences. First, they drove up rents and thereby pushed these projects closer to default. Second, inflated appraisals led to increased exposure to the federal government when an overinflated mortgage went into foreclosure, at comparatively little risk to the developer or the lender.

Adams also testified that rents were set at or very near the maximum rents allowed in over 70% of the co-insured projects studied.[156] In 13 out of 20 MRP projects reviewed by the Congressional Research Service (CRS), HUD provided co-insurance for projects in weak rental markets that already were experiencing high vacancy rates.[157]

In addition, knowledgeable witnesses testified that the program failed due to loose entry standards, inadequate HUD staffing, domination of the industry by a few co-insurers whose practice of over-mortgaging drove out the better lenders, and lack of political will by HUD to correct problems.[158]

IV. Escrow Accounts

An example of the mismanagement of efforts to privatize HUD functions during this same period involved escrow accounts.

HUD guarantees the mortgage loans of hundreds of thousands of homebuyers. Those mortgages that go into default are then resold by escrow agents who contract with HUD. The agents collect the proceeds and are supposed to pass them on to the Department, minus a small commission. Instead, some kept a significant portion of the money.

The Inspector General reported deficiencies in internal controls in the property disposition process.[159] HUD lacked adequate oversight at the central and regional offices due partly to a ten-fold increase in HUD-acquired properties between 1984 and 1988.[160]

Lack of sufficient monitoring and quality controls resulted in findings of abuse by some escrow agents who discovered that they could misappropriate foreclosure funds intended for HUD without great risk of detection. The HUD IG criticized the Department's handling of property sales because of, "significant delays in transferring funds to HUD and HUD's lack of control over the activities of closing agents."[161]

The most noteworthy case involved Marilyn Harrell, a closing agent in Maryland who has since pled guilty to having stolen $5.5 million in FHA funds and spending it on her own business ventures and on charitable organizations. For the latter, she was nicknamed "Robin HUD" by the media. Harrell contracted with HUD to be a closing agent, although she received no background check and no training from HUD.[162]

V. Public Housing Authority Decontrol Program

Yet another program mismanaged during the Pierce Administration was the Public Housing Decontrol Initiative, touted by HUD as "an important step in the deregulation of public housing..."[163] Under the initiative, HUD relaxed its monitoring of PHAs which met seven established performance standards.[164]

Any PHA meeting the seven standards enjoyed, among other things, a relatively limited budget review by the HUD regional office, was allowed to contract for services without prior HUD approval, and was granted limited HUD review in the PHA's use and oversight of Comprehensive Improvement Assistance Program (CIAP) funds.[165]

On February 6, 1990, the House Subcommittee on Employment and Housing conducted a hearing on the blatant misuse of funds by the Passaic, New Jersey PHA, one of about 650 PHAs which had been decontrolled pursuant to the Public Housing Decontrol Initiative. An Inspector General audit of Passaic's CIAP program revealed shocking abuses of federal funds. In one year, Paul Marguglio, Passaic's Executive Director, collected salaries for four jobs -- a full-time Executive Director position, a full-time Modernization Director position, a part-time contracting officer, and a part-time purchasing agent position. Incredibly, Marguglio still managed to charge compensatory time for working overtime hours! He also was given a $7,500 expense account and a $10,000 retirement annuity. In 1988 alone, the Inspector General estimated that Marguglio was paid over $245,000.[166]

The Inspector General found other "irregularities" with Passaic salaries. For example, Marguglio's wife Louise was paid more than $95,000 for working only one day, and Donald Pieri, the Deputy Executive Director, collected $106,868 in 1988 for two full-time positions. Apparently, Passaic employees manipulated the accounting of CIAP funds to provide a cash flow for these lavish remunerations.[167]

On February 23, 1990, shortly after the House hearing on Passaic, the Inspector General released the results of its audit of the Public Housing Decontrol Initiative. the report concludes that, as designed, the objectives of the decontrol program -- to provide greater flexibility to the PHAs and allow HUD the discretion to concentrate on monitoring troubled PHAs -- were not being achieved. this was due in part to the fact that the established performance standards did not provide an acceptable measure of a PHA's performance.

Furthermore, the program was poorly implemented by HUD. For instance, a review of 17 decontrolled PHAs found that 15 did not meet all of the seven performance standards. In fact, some PHAs felt that HUD regional staff pressured them into being decontrolled. By that time, HUD had already suspended the Public Housing Decontrol Program until new criteria and implementation guidelines are developed.[168]

ENDNOTES

1. Dr. Morton Schussheim, Senior Specialist in Housing, Congressional Research Service, testified that if fair market rents were set "even 10 percent too high for every 100 units that were provided, we could have gotten perhaps another 10 units or more." Schussheim, Testimony, Senate Banking Committee, August 2, 1989 at p. 185.

2. Report to the Congress, Office of the Inspector General, HUD, for the six month period October 1, 1989 to March 31, 1990, No. 22 at p.5.

3. Section 8(e) of the U.S. Housing Act of 1937, as amended, 42 USC 1437f (e).

4. Section 882 of Title 24 of the Code of Federal Regulations (24 CFR 882).

5. One news report described how this 15 year federal commitment was parlayed into a $10 million construction loan. Wall Street Journal, "Housing Subsidy Plan for the Poor Helped Contributors to GOP," May 25, 1989.

6. "Audit of Section 8 Moderate Rehabilitation Program," Office of the Inspector General, HUD, 89-TS-103-0005, April 26, 1989, p. 49.

7. Id. at 50

8. "Housing Subsidy Plan For the Poor Helped Contributors to GOP," Washington Post, May 5, 1989 at p.1.

9. Samuel Pierce, former Secretary of HUD, Testimony, House Hearing, May 25, 1989 at p. 82.

10. Paul Adams, inspector General, HUD, Prepared Statement, Hearings, May 17, 1989 at p.23.

11. Pierce at p. 223.

12. Adams, Testimony, House Hearings, August 2, 1989 (Unofficial Transcript) at p. 164.

13. According to the Inspector General, Pierce based his decision that the waiver of Fair Share gave him absolute discretion in the use of Mod Rehab funds upon an oral opinion to that effect by then General Counsel John Knapp. In his initial testimony before the House Subcommittee on Employment and Housing, Knapp accepted that statement and even attempted to justify it. John Knapp, former General Counsel, HUD, Testimony, House Hearings, May 25, 1989 at pp. 242-250. However, in his subsequent appearance, Knapp denied ever having given such an opinion, stating that he had no idea of the source of the statement that he had. Knapp, Testimony, House Hearings, July 31, 1989 (Unofficial Transcript) at p. 165. Interestingly, Pierce told the subcommittee that Knapp had given such a verbal opinion. Pierce at p. 188.

14. Adams, Prepared Statement, Hearings, Senate Banking Committee, May 17, 1989 at p. 26.

15. William Connolly, Director, Housing for New Jersey, House Hearings, June 29, 1989 (Unofficial Transcript) at p. 187.

16. Tom Lantos (D. California), Chairman, House Hearings, June 20, 1989, (Unofficial Transcript) at p. 118.

17. Paul Manafort, Partner, Black, Manafort, Stone, & Kelley, Testimony, House Hearings, June 20, 1989 (Unofficial Transcript) at p. 105.

18. e.g. Newsweek, "The HUD Scandal -- Anatomy of a Ripoff," August 7, 1989; New York Times, "Housing Group Must Forfeit $700,000," October 18, 1989, Washington Post, "HUD Seeking to Recover $700,000," October 19, 1989.

19. "Report on Development Costs and Related Matters -- Cypress Mill Plantation, Brunswick, Georgia," Office of the Inspector General, HUD, 89-AT-211-1023, May 19, 1989 at p. 3. Some of the particular audit problems included land improvements, builder's general overhead and profit.

20. Silvio DeBartolomeis, former Deputy Assistant Secretary, HUD, Testimony, House Hearings, June 13, 1989 at p. 413.

21. James Watt, former Secretary, U.S. Department of the Interior, Testimony, House Hearings, June 9, 1989 at p. 372. Alternatively, Watt offered another view at an earlier hearing: "The problem was that the HUD bureaucracy was not processing the public housing authority application....After explaining the situation in some detail to Secretary Pierce, and outlining the existing political and technical support for the project, I explained our frustrations, the frustrations in not getting the career bureaucracy to review the State of Maryland's application." Id. at p. 353.

22. Adams, Prepared Statement, Senate Banking Committee, May 17, 1989 at p. 23.

23. Id. at 24.

24. Anna Marie McCarthy, Budget and Legislative Coordination, HUD, as reported by Congressional Research Service in telephone interview, September 5, 1990.

25. L. Marion, Budget and Legislative Coordination, HUD, as reported by Congressional Research Service in telephone interview, September 5, 1990.

26. Adams, Prepared Statement, Senate Banking Committee, May 17, 1989 at p. 24.

27. Pierce at p. 260.

28. In one instance, President Reagan failed to recognize Pierce at a gathering of municipal officials and referred to Pierce as "Mr. Mayor." Wall Street Journal, "Pierce May Have Kept Hands Off, but Projects of Pals Sailed Through," July 12, 1989.

29. Pierce stated, "...I intend to quickly but carefully review the programs at HUD with a view toward cutting unnecessary costs and developing new ways of executing the agency's mission with fewer dollars....I believe that if the efficiency of management at HUD is improved, which is also one of my aims, HUD will be able to deliver a

higher quality service with less money." Pierce, Senate Banking Committee, Nomination Hearings, 97th Cong., v. 401, January 13, 1981 at p. 10.

30. Pierce, Testimony, House Hearings, May 25, 1989 (Unofficial Transcript) at p. 82.

31. e.g. "Playing Favorites at HUD: Latest Twist on Old Game," Los Angeles Times, July 30, 1989.

32. Id.

33. Washington Post, "Problems Plagued HUD Long Before Reagan Era, Kemp Says," June 18, 1989, citing a television interview on CNN's "Evans and Novak" show.

34. Pierce testified that, "I did not have hands on," management of the housing program. Pierce, House Hearings at p. 258.

35. Pierce, House Hearings at p. 212.

36. DeBartolomeis at p. 415.

37. Thomas Demery, former Assistant Secretary of Housing, HUD, Testimony, House Hearings, May 23, 1990 (Unofficial Transcript) at p. 144.

38. e.g., Dubois Gilliam, former Deputy Assistant Secretary for Program Policy Development and Evaluation, HUD, Testimony, House Hearings, May 2, 1990 (Unofficial Transcript) at pp. 29-30, 64; Gilliam, Testimony, House Hearings, May 4, 1990 (Unofficial Transcript) at pp. 19-20, 96-98.

39. Gilliam, May 4, 1990 at pp. 100-103.

40. Gilliam, May 2, 1990, at pp. 38-39.

41. Lantos, House Hearing, May 2, 1990, (Unofficial Transcript) at p. 41.

42. Gilliam, May 2, 1990 at p. 41.

43. New York Times, "Documents Show Active Pierce Role on Fund Requests," July 23, 1989.

44. Id., citing letter dated January 18, 1986.

45. Shirley Wiseman, former Federal Housing Commissioner, Testimony, House Hearings, July 14, 1989, (Unofficial Transcript) at p. 25.

46. Janet Hale, former Acting Assistant Secretary for Housing, HUD, Testimony, House Hearings, July 14, 1989, (Unofficial Transcript) at p. 54. Hale testified that the project was assisted with mod rehab rent subsidies, FHA insurance, and UDAG funds.

47. Id. at 20-23.

48. Id. at pp. 38-39.

49. Id. at p. 51.

50. Lantos, House Hearings, July 14, 1989, (Unofficial Transcript) at pp. 40-41.

51. Gilliam, May 2, 1990 at p. 46.

52. Id.

53. In an interview with the staff of the HUD/ Mod Rehab Subcommittee on May 8, 1990, Gilliam suggested that HUD was a "dumping ground" for people who did not fit into any other agencies. He mentioned a number of political employees who were hired with minimal qualifications -- Janice Golec (Deputy Assistant Secretary for Field Operations, Environment and Energy and Later Acting Assistant Secretary for Community Development), Jim Baugh (General Deputy Assistant Secretary for Public and Indian Housing), Janet Hale (Deputy Assistant Secretary for Policy, Financial Management and Administration and later Acting Assistant Secretary for Housing), and Deborah Gore Dean (Executive Assistant to the Secretary). No other agency would have accepted these appointees, but Pierce was unable to fight the decisions of the Office of Presidential Personnel. Gilliam said that Pierce wanted John Knapp to be Under-Secretary but instead got Cari Covitz, and Pierce wanted Lance Wilson as Assistant Secretary for Housing but instead got Tom Demery.

54. New York Times, "Pierce at HUD: Eight Years of Hands Off Management," June 17, 1989.

55. Joseph Strauss, former Special Assistant to the Secretary, HUD, Testimony, House Hearings, June 22, 1989 (Unofficial Transcript) at p. 159.

56. Gilliam, April 30, 1990 at pp. 122-123.

57. Gilliam, May 2, 1990 at p. 46.

58. Biographical material submitted to the Senate Committee on Banking, Housing and Urban Affairs prior to Dean's confirmation hearing.

59. Nomination of Deborah Gore Dean, Senate Banking Committee, August 6, 1987.

60. Id. at p. 32.

61. Id. at p. 47.

62. Lantos, House Hearing, (Unofficial transcript), July 31, 1989 at p.28.

63. According to HUD Office of Personnel, the following people occupied the position of Assistant Secretary:

George Hipps, General Deputy Assistant Secretary
Philip Winn, General Deputy Assistant Secretary
Philip Abrams, General Deputy Assistant Secretary

Calvert Brand, General Deputy Assistant Secretary
Maurice Barksdale, Assistant Secretary
Shirley Wiseman, General Deputy Assistant Secretary
Janet Hale, General Deputy Assistant Secretary
Silvio DeBartolomeis, General Deputy Assistant Secretary
Thomas Demery, Assistant Secretary

According to HUD, the Acting Assistant Secretary title is not used in Housing since the General Deputy Assistant Secretary has the same authority as the Assistant Secretary.

64. Dean Confirmation Hearing, Senate Banking Committee, August 6, 1987 at p. 53.

65. DeBartolomeis at pp. 20, 25, 27-29.

66. New York Times, "Ex-Aide Assailed in Audit Points Finger at Pierce," May 23, 1989.

67. Washington Post, "HUD Aides Clash Opened Door to Inquiries," July 7, 1989.

68. Philip Abrams, former General Deputy Assistant Secretary, Testimony, House Hearings, June 22, 1989, (Unofficial Transcript) at p. 171.

69. New York Times, "The Dean Files: Flattery in the Quest for Power," July 23, 1989.

70. DeBartolomeis, Testimony, House Hearings, April 25, 1989 at p. 258.

71. Id. at 258-259.

72. This view seems to agree with Gilliam's testimony who stated that some projects under review had not even sent in formal written applications. Gilliam at pp. 35-36.

73. J. Michael Dorsey, former General Counsel, HUD, House Hearings, May 25, 1989 at pp. 311-313.

74. Gilliam, May 2, 1990 at p. 37.

75. Strauss at p. 18.

76. Adams, Senate Banking Committee, May 17, 1989 at p. 15.

77. Adams, Senate Banking Committee, August 2, 1989 at p. 174.

78. Id. at 258.

79. J. Michael Queenan, former Director of Housing Development Division, Denver Regional Office, HUD, Testimony, House Hearings, October 13, 1989, (Unofficial Transcript) at p. 110.

80. Strauss at p. 17.

81. Gilliam, April 30, 1990 at p. 111. Projects included hotel developments in Decatur, Georgia ($2,625,000); Lorrain, Ohio ($1,378,000); Augusta, Georgia ($617,000); Erie, Pennsylvania ($3,983,000); Biloxi, Mississippi ($1,850,000), Sioux Falls, South Dakota ($2,100,000).

82. New York Times, "Pierce Aide Profited Greatly After Leaving Post at HUD," July 27, 1989.

83. Id.

84. Manafort at p. 80.

85. Adams, Senate Banking Committee, August 2, 1989 at p. 173.

86. Wall Street Journal, "Favored Friends -- Housing Subsidy Plan For the Poor Helped Contributors to GOP," April 25, 1989.

87. DeBartolomeis, June 13, 1989 at p. 412.

88. Adams, Senate Banking Committee, August 2, 1989 at p. 172.

89. New York Times, "Documents Show Active Pierce Role on Fund Requests," July 23, 1989.

90. William L. Taylor, former Republican state chairman, Florida, Testimony, House Hearings, July 24, 1989, (Unofficial Transcript) at pp. 60-61. Taylor also referred to five projects on which he earned $190,000.

91. Id. at 40.

92. Judith Siegel, Developer, Testimony, Senate Banking Committee, May 17, 1989 at p. 103.

93. Siegel, Testimony, House Hearings, May 25, 1989 at p. 141.

94. Fred Bush, consultant, Testimony, House Hearings, May 25, 1989 at p. 272.

95. According to one news report, an application sent to HUD included information regarding Bush's, "extensive network throughout the White House and most federal agencies, as well as with congressional leaders in both the Senate and House of Representatives." Wall Street Journal, "Ambassador-Designate Frederick Bush Denies Using Influence to Get HUD Jobs," June 30, 1989.

96. Manafort at p. 110.

97. Wall Street Journal, "Consultant Admits 'Influence Peddling' to Get Rent Subsidies for HUD Project," June 21, 1989.

98. Watt at p. 397.

99. New York Times, "Files Show Pierce Helped Friends and the G.O.P.," August 4, 1989, citing a letter dated June 6, 1986.

100. Adams, Prepared Statement, Senate Banking Committee, August 2, 1989 at p. 178.

101. Adams, Testimony, Senate Banking Committee, May 17, 1989 at pp. 36-39.

102. Id. at pp. 16-17.

103. New York Times, "HUD Lenders in New York Urged Housing Industry to Give to Causes," June 24, 1989.

104. New York Times, "HUD Leaders in New York Urged Housing Industry to Give to Causes," June 24, 1989.

105. Executive Order 12674, "Principles of Ethical Conduct for Government Officers and Employees," April 12, 1989. Although this executive order was not adopted until 1989, it replaced a similar rule that included identical language with regard to the use of public office for private gain. 5 C.F.R. Section 735.201a.

106. Office of Government Ethics, Opinion, 87-11, September 9, 1987. The opinion establishes that it is improper for a university to solicit charitable contributions to a fund created in honor of a recently appointed member of its governing commission. The opinion states that the prohibition against using one's public office for private gain extends to the solicitation of such contributions: "...the use of the individual's name, his Government title, or his Government position, directly or indirectly, in the solicitation of funds for the university or for this particular fund would be improper. It would create the appearance that the individual is using his Government position for private gain, which in this case would be the private gain of the university." A HUD spokesperson, Mary Brunette, agreed that the Department follows a similar interpretation of the solicitation of contributions for charities by HUD employees. New York Times, "HUD Leaders in New York Urged Housing Industry to Give to Causes," June 24, 1989.

107. Siegel, House Hearings, May 25, 1989 at p. 151.

108. John M. Ols, Jr., Director, Government Accounting Office, Testimony, Senate Banking Committee, August 2, 1989 at p. 151.

109. Lantos, House Hearings, June 22, 1989, (Unofficial Transcript) at p. 192. The $26 million figure includes nearly $20 million in subsidized rents and rehabilitation costs and $6 million in low income tax credits.

110. Lantos, House Hearings, June 20, 1989, (Unofficial Transcript) at p. 48.

111. Manafort at pp. 154, 198.

112. Wall Street Journal, "Ex-HUD Chief Helped Get Funds for a Project Boosted by Friends," July 3, 1989.

113. The HUD IG reported that the definition of moderate rehabilitation had increased from roughly $6500 per unit to over $26,000 per unit. "Audit of Section 8 Moderate Rehabilitation Program," Office of the Inspector General, HUD, 89-TS-103-0005, April 26, 1989.

114. Dr. Morton Schussheim, Senior Specialist in Housing, Congressional Research Service, Prepared Statement, Senate Banking Committee, August 2, 1989 at pp. 186-188.

115. See, Co-Insurance, Chapter 2 of Part Two of this report.

116. Victor Cruse, CFM Development Corp., Testimony, House Hearings, October 2, 1989, (Unofficial Transcript) at p. 144.

117. Connolly at pp. 141; 183; 188-189.

118. Lantos, House Hearings, June 20, 1989, (Unofficial Transcript) at p. 137.

119. Bruce Peterson, Mayor, Township of Upper Deerfield, Testimony, House Hearings, June 20, 1989, (Unofficial Transcript at pp. 27-28.

120. Edward Fleetwood, Housing Officer, Upper Deerfield Township, Testimony, House Hearings, June 20, 1989, (Unofficial Transcript) at p. 56.

121. "Audit of Section 8 Moderate Rehabilitation Program," Office of the Inspector General, HUD, 89-TS-103-0005, April 26, 1989 at pp. 6-7.

122. Strauss, House Hearings, Unofficial Transcript, June 22, 1989, line 2441.

123. Gilliam, Testimony, House Hearings, April 30, 1990, May 2, 1990, and May 4, 1990. Gilliam was granted immunity by the Subcommittee. At the time of his testimony, Gilliam was completing his sentence resulting from his conviction in 1989 for accepting gratuities while at HUD and for criminal conspiracy to defraud the federal government.

124. Gilliam, April 30, 1990 at pp. 19-20.

125. Gilliam, April 30, 1990 at pp. 54-57.

126. Gilliam, April 30, 1990 at pp. 30-31; 54-56

127. Gilliam, April 30, 1990 at p. 39.

128. Id. at pp. 43-46.

129. Gilliam, April 30, 1990 at p. 125.

130. Gilliam, May 4, 1990 at pp. 25-26.

131. Gilliam, May 4, 1990 at 18-20. Ironically, Gilliam mentioned one nonpolitical project that was inadvertently placed on the list and funded, much to the amusement of the participants in the meeting.

132. Bush, June 29, 1989 at p. 29.

133. Lantos, June 29, 1989 at pp. 30-31, citing a memo from the Office of Program and Policy Development, March 19, 1986. Other problems with the project included: lack of significant benefit to the city of San Juan, ambiguous project objectives, lack of cost justification.

134. Bush at p. 31.

135. "Audit Report -- Evaluation of Cost and Price Proposal in the Amount of $296,380," Office of the Inspector General, HUD, 86-AO-261-1011, August 25, 1986 at p.1.

136. Gilliam, May 4, 1990 at pp. 13-14.

137. Id. at p. 35

138. George Hipps, Jr., Senior Vice President, P.W. Funding, Inc., on behalf of the Mortgage Bankers Association, Testimony, House Hearings, June 30, 1989, (Unofficial Transcript) at p. 25.

139. "Multifamily Housing Internal Audit of the Section 223(f) Co-insurance Program," Office of the Inspector General, HUD, V6-TS-112-0004, November 5, 1985.

140. Id. at p. 2.

141. Adams, Prepared Statement, Senate Banking Committee, September 28, 1989 at p. 365.

142. Id. at 366.

143. Letter, Ronald F. Poe, President, Mortgage Bankers Association of America, to Secretary Pierce, HUD, July 8, 1986.

144. Adams, Prepared Statement, Senate Banking Committee, September 28, 1989 at p. 375.

145. Federal Housing Administration, audited financial statements, September, 1988.

146. "Report on Audit of the Section 223(f) Co-insurance Program," Office of the Inspector General, HUD, 89-TS-119-0002, December 9, 1988, p. 3.

147. "Report on Benton Mortgage Company Knoxville, TN, HUD-Approved Co-insurance Lender," Office of the Inspector General, HUD, 89-TS-221-1005, March 20, 1989, p. ii.

148. Id.

149. Id. at i.

150. Walter Sevier, Deputy Regional Administrator, HUD, Testimony, Senate Banking Committee, September 28, 1989 at p. 436.

151. Carla Hills, former Secretary of HUD, Testimony, House Hearings, July 17, 1989, (Unofficial Transcript) at pp. 17;19-87.

152. Lynda Murphy, Lawyer, Testimony, House Hearings, July 24, 1989, (Unofficial Transcript) at pp. 226-227.

153. Washington Post, "HUD Targets Co-insurance Program," June 26, 1989. In the article, Robert M. O'Toole, Vice President of the Mortgage Bankers Association of America, is quoted as saying, "There was an extremely competitive environment, and developers went lender shopping. They shopped lenders to get the highest possible loans...[and] they would get an appraisal report to justify the value."

154. Adams, Testimony, House Hearings, June 30, 1989, (Unofficial Transcript) at p. 13.

155. Sevier at p. 429.

156. Adams, Testimony, Senate Banking Committee, August 2, 1989, at p. 173.

157. Schussheim at p. 168.

158. Peter Monroe, General Deputy Assistant Secretary for Housing, Deputy Federal Housing Commissioner-Designate, HUD, Testimony, Senate Banking Committee, September 28, 1989 at p. 397.

159. Report to the Congress, Office of Inspector General, HUD, for the six month period April 1, 1988 to September 30, 1988, No. 20 at p. 10.

160. Adams, Testimony, House Hearings, June 16, 1989 at p. 536.

161. Report to the Congress, Office of the Inspector General, HUD, for the six month period April 1, 1987 to September 30, 1987, No. 18 at p. 27.

162. Marilyn Harrell, closing agent, Testimony, House Hearings, June 16, 1989 at pp. 564-565.

163. HUD Handbook No. 7460.5, issued October 16, 1987, suspended January 31, 1990; News Release: "HUD Honors Individuals at Public Decontrol Appreciation Ceremony," HUD No. 88-25, February 24, 1988.

164. The seven performance standards were:

(1) Operating Reserves, exclusive of Tenants Accounts Receivable, are at least 30 percent of maximum Operating Reserves.
(2) Operating Reserves are less than or equal to income.

(3) Annual utility consumption, as compared to the average of the previous three years' rolling base consumption, which has been adjusted for variances in heating degree days has not increased by more than five percent.
(4) PHA is a High Occupancy PHA or is meeting the occupancy goals of an approved Comprehensive Occupancy Plan.
(5) Annual rent collections are at least 90 percent of annual rents chargeable plus year-end rental accounts receivable.
(6) Annual average number of vacancy days per turnover is not more than 30 calendar days.
(7) One hundred percent of the dwelling units have been inspected using Housing Quality Standards as a minimum standard." (acronyms omitted), HUD Handbook No. 7460.5.

165. HUD Handbook No. 7460.5, paragraph 3-2.

166. Adams, Testimony, House Hearings, February 6, 1990, (Unofficial Transcript) at pp. 3-5.

167. Id. at pp. 3-5; 57-58.

168. Office of the Inspector General, HUD, Audit: "Public Housing Agency Decontrol Program," 90-TS-101-0006, February 23, 1990, p. 1, 3-6; (PHA), "Suspension of the Public Housing Decontrol Program," Notice PIH 90-5, January 31, 1990.

PART FOUR
RESPONSE TO SCANDALS

CHAPTER ONE
INTERNAL CHANGES AT HUD IN RESPONSE TO THE HUD SCANDALS

Upon taking office in February 1989, Secretary Kemp inherited an agency in disarray, mired in scandal, and under intense scrutiny from the Congress and the media. In order to learn more about the nature and extent of the problems plaguing the agency, he met with the Inspector General for two days and was briefed regarding ongoing audits, problems, and investigations.[1] In his first few months in office, Kemp took a number of actions relating to the troubled programs that had been the subject of the Inspector General's audits and congressional investigation. These included the Moderate Rehabilitation Program and Multifamliy Co-insurance.

In the fall of 1989, Kemp unveiled a series of reforms that became the basis for the HUD Reform Act of 1989. Those reforms were a comprehensive response to most of the problems that had been uncovered by the Inspector General and the congressional investigations.

This chapter will briefly describe a number of internal actions taken by Secretary Kemp to resolve what he described as the "long-term systemic problems in many of HUD's programs which made them susceptible to fraud, waste, abuse, and political influence"[2] Most of these actions are described in the two Secretary's Semiannual Reports to Congress pursuant to the Inspector General Act.[3]

I. Programmatic Changes

A. Moderate Rehabilitation Program

Upon learning from the Inspector General of the problems with the Section 8 Moderate Rehabilitation program, Kemp cancelled the program. He was concerned about the harm that decision might cause persons engaged in rehabilitation activities and upon the public housing authorities (PHAs) that had received 1988 allocations, but concluded that the program:

> Was so fundamentally flawed, it was so systemically poisoned, it seemed to me at the time the only way to get a handle on it ... was to cancel and then reopen. We did in June.[4]

Kemp cancelled funds not under contract with PHAs and they were returned to headquarters. HUD notified its field offices on April 10, 1989 to inform PHAs not to take certain actions regarding specific projects or housing assistance payments contracts until HUD had reviewed the project selection process and the rent calculations.[5] On May 8, 1989, HUD transferred responsibility for establishing contract rents in co-insured projects from participating lenders to HUD field staff so as to avoid the problem of excessive rents which had been exposed by the Inspector General.[6]

HUD completed a review of projects in the Mod Rehab program pipeline on January 31, 1990 to determine if rents were correctly calculated and if project selection procedures were followed. By December 31, 1990, HUD intends to complete a study of 300 projects to determine if excess rents were paid and to collect overpayments.

HUD has issued an interim funding plan for the program consistent with the HUD Reform Act and has established by regulation a 100-unit project cap, a $3,000 per unit minimum rehabilitation expenditure, and provisions restricting subsidy layering.

B. Co-insurance

Secretary Kemp also learned of serious problems in the Multifamily co-insurance program, including the failure of participating lenders to comply with underwriting requirements and ineffective monitoring. One his first acts was to suspend the DRG Funding Corporation from the program, which at the time had defaults of $500 million and a portfolio of over $1 billion. As discussed elsewhere in this report, Pierce had reinstated DRG to the program. Kemp was "shocked at what DRG had been allowed to get away with," and concluded that there was no excuse for the failure of HUD to have suspended DRG sooner.[7]

After failing to restructure the program in the fall of 1989, HUD terminated the program, to be replaced by a designated underwriting program in which certain processing functions will be performed by participating lenders but final underwriting will be done by HUD.[8] HUD has also suspended a number of other lenders from the program, including Benton Mortgage Company, which suspensions are the subject of on-going litigation.

C. Single Family Property Disposition

Through this program, HUD contracts with closing agents to manage and sell single family properties acquired as a result of foreclosure. Problems uncovered included selling properties below their fair market value, lack of controls over the money generated by the sales, and a lack of monitoring of closing agents by HUD. This resulted in the embezzlement of millions of dollars by several agents, most notably Marilyn Harrell, alias "Robin HUD". In response to these problems, HUD has started bimonthly monitoring and oversight of agents and is in the process of implementing a Single Family

Accounting and Management System--SAMS--to assist with handling the single family property inventory and critical information related to it.[9]

D. Title X Land Development Program

This program authorized HUD to insure mortgages for land development, including acquisition costs for land, site improvements, and related expenses and fees. The Inspector General had uncovered abuses in the program, including the use of funds for a golf course and high default rates. Secretary Kemp also found that the program did nor serve low- and moderate-income persons. On July 31, 1989, Kemp suspended the program and it has since been terminated.[10]

E. Retirement Service Center Program

This program was designed to insure mortgages for the financing of multifamily housing for person 70 years of age or older who can live independently and afford to pay market rates for certain services such as meals and transportation. The Inspector General found that these centers were suffering a very high default rate because of poor underwriting by HUD and co-insuring lenders. Kemp also found that this program did not properly address the needs of low- and moderate-income persons. In July 1989, HUD suspended the program.[11]

Highlights of other programmatic changes follow:

F. Single Family Loan Origination

This program, by providing mortgage insurance, encourages lenders to provide financing to first time home buyers who do not other wise qualify for conventional loans by providing mortgage insurance. The problems uncovered with this program included inflated appraisals, inadequate appraisal reviews, and inaction on removing poorly performing appraisers. In response HUD has tighten requirements for appraisers and debt service to net income ratios, and has barred investors from originating loans.[12]

G. Title I Manufactured Housing

HUD insures loans that private lenders make to individuals to repair and improve existing buildings or manufactured housing. It also allows, however, dealers to originate these loans thus creating a conflict of interest. Lenders are required to monitor dealers to insure prudent underwriting, but have not done so. To prevent these problems from reoccurring, Title I premiums have been increased and dealer participation in originating loans has been tighten.[13]

H. Government National Mortgage Association

GNMA guarantees privately-issued securities backed by pools of government-insured FHA or guaranteed VA loans through its Mortgage Backed Securities (MBS) program. Holders of these securities receive principal and interest payments due on the pooled mortgages. GNMA's defaulted issuer portfolio increased dramatically because of problems with defaults in HUD's Co-insurance and Title I programs as well as VA's limited guarantee on its loans. As a result, GNMA has awarded subservicer contractors to issuers who will expedite takeover and servicing of defaulted single family portfolios in order to same the Department millions of dollars in servicing costs. It is also increasing its monitoring of participants in its MBS program.[14]

I. Comprehensive Improvement Assistance Program

CIAP provides financial assistance to PHA's to upgrade their housing facilities so they continue to be safe and habitable for low-income families. The IG found that this program was inadequately managed in that improvements are approved without determining whether or not the project will be viable after the modernization nor whether the PHA has the ability to carry out the modernization effort. HUD's corrective plans include plans for better assessments of PHA's ability to carry out its work and stricter procedures for approving budget changes.[15]

J. Community Development Block Grants

CDBG provides money on a formula basis to communities to carry out development activities for neighborhood revitalization, economic development, and improved community facilities. In the past, the IG has uncovered instances where program funds have been misused or wasted which went undetected because of a lack of monitoring of subgrantees by the communities receiving CDBG money. HUD has updated its regulations on monitoring requirements by its grantees and has provided training to its Field staff for more effective evaluation of grantee monitoring.[16]

II. Development of New Programs

As a means of assessing potential design and implementation flaws for new programs, HUD has instituted a procedure whereby the Inspector General conducts a risk assessment of the program. The program will then be monitored and evaluated after implementation for the detection and elimination of any problem as it might occur.[17]

III. Internal Controls and Material Weaknesses

Probably the most serious and pervasive of HUD's problems now facing the Secretary are the weaknesses in HUD's management and financial systems. Such systems are intended to provide an agency's management with vital data needed for managing programs, determining their financial stability, and safeguarding them from abuse. An annual evaluation of these systems by each federal agency is required by the Federal Managers' Financial Integrity Act, and a report must be made to the Congress and the President on describing weaknesses found and corrective actions the agency plans to take.

Secretary Kemp, upon taking office, undertook an objective appraisal of HUD's internal controls problems, something which had been less than forthcoming under Secretary Pierce. As a result, HUD identified 42 material weaknesses in its internal and management control systems[18], designating the following 11 as the Department's most serious:

- Material Nonconformance in Financial Systems
- Single Family Loan Origination-Appraisals
- Single Family Property Dispositions-Closing Activities
- Section 8 Subsidy Payment Process
- Multifamily Co-insurance Program
- Title I Supervision of Home Improvement Dealers
- Title I Manufactured Housing Loans
- Use of Assets of Multifamily Projects
- Management of Public Housing Modernization Projects
- Entitlement Grantee Monitoring of Subgrantee Performance[19]

The Act also requires agencies to develop and implement plans to correct the material weaknesses uncovered. Corrective actions planned for some of the Department's more serious material weaknesses include the:

- Creation of the Secretary's Task Force on Program Financial Management to identify systemic management problems in 26 financial management activities and to adopt action plans and establish priorities.

- Development of the Secretary's Management Report to track the implementation of important management and policy initiatives and reforms.

- Transfer of the Internal Controls Program from the Office of Finance and Accounting to the Office of Management and Quality Assurance to give it more independence. In March 1990, HUD began publishing a monthly Secretary's Management Report on Material Weaknesses to monitor completion of corrective actions.[20]

Corrective actions on all 42 identified material weaknesses are contained in HUD's December 1989 FMFIA Report to the President.

IV. Ethics

In reaction to the numerous scandals which had surfaced at HUD, and with input from the Department, Kemp presented Congress with a reform package. These reforms, enacted as part of the HUD Reform Act of 1989 include:

-- Consultant Registration and Fee Disclosure: All consultants, lobbyists, and lawyers doing business with HUD must register themselves as such with the Department. In addition, they must disclose the fees paid to them by their clients.[21]

-- "Sunshine" Decision Making: All HUD's funding decisions will be publicly announced and published in the Federal Register so that the Department's decision process regarding its funds is clearly known.[22]

-- Elimination of Discretionary Funding: Under certain programs, the Secretary is permitted to spend funds in a discretionary manner without competition. The elimination of this type of funding will require HUD's money to be based on formula and allocated by need and priority.[23]

-- Chief Financial Officer: Many of HUD's problems stem from the lack of a unified financial and accounting system. The CFO will oversee the development and implementation of such a system. Although this position was to have been filled by March, to date HUD is still in the process of trying to hire someone.[24]

-- Monitoring and Evaluation: Another weak aspect of HUD's program management is its limited effort to monitor and evaluate its programs. As required by the HUD Reform Act, HUD is now required to set-aside 0.5 percent of its program funds for this purpose.[25]

V. Task Forces and Internal Studies

In a order to get a concerted and comprehensive effort underway to attack HUD's myriad of problems, Secretary Kemp has organized some internal task forces and has contracted with several outside consultants to conduct various internal studies of the Department. The Task Forces are:

Secretary's Task Force on Program Financial Management: The purpose of this task force is to identify the systemic management problems in 26 key financial activities. Through its assessment, it has proposed more than 1,000 actions and has begun to rank these to determined priorities for implementation.[26]

Assets Recovery Strike Force: Secretary Kemp established a strike force of 10 HUD attorneys specifically to recovery assets and take actions against HUD closing agents who embezzled money from HUD. The task force is working in conjunction with the Department of Justice, U.S. Attorney's Offices, the FBI, and the IG. To date, $4.3 million dollars has been recovered as a result of these efforts.[27]

Through its own initiation and as directed by the HUD Reform Act, the Department also has on-going or planned over 30 internal studies to be conducted by outside consultants, contractors, and HUD staff. These studies will examine numerous program and management processes, systems, and policies and make recommendations to HUD on needed improvements to such. The areas on which the studies will focus cover the gambit of HUD activities. These include reviewing multifamily assisted housing programs; reviewing methods to determine Field staff allocations; assessment of and recommendations on improving FHA accounting operations; and an analysis of the effects of tax laws on the management of insured multifamily projects.[28]

ENDNOTES

1. Jack Kemp, Secretary of HUD, Testimony, Hearings, Vol. 2, May 16, 1990 at p. 605.

2. Department of Housing and Urban Development, "The Secretary's Semiannual Report to the Congress," No. 1 (for the six month period April 1, 1989 through Sept. 30, 1989) at p. 9.

3. The Inspector General Act was amended in 1988 to require the Secretary of various agencies, including HUD, to submit semiannual reports to the Congress regarding Inspector General audits and management actions taken in response to audit recommendations. Section 106, Inspector General Act Amendments, P.L. 100-504.

4. Kemp, Testimony, House Hearings, July 11, 1989 (unofficial transcript) at p. 22.

5. Department of Housing and Urban Development, "The Secretary's Semiannual Report to the Congress," No. 1 (for the six month period April 1, 1989 through Sept. 30, 1989) at p. 11.

6. Department of Housing and Urban Development, "The Secretary's Semiannual Report to the Congress," No. 2 (for the six month period October 1, 1989 through March 31, 1990) at pp. 16-19.

7. Kemp, House Hearings at p. 29.

8. Department of Housing and Urban Development, "The Secretary's Semiannual Report to the Congress," No. 2 (for the six month period October 1, 1989 through March 31, 1990) at p. 19. For a complete review of the actions taken by HUD, including litigation, and subsequent rule-making, see Chapter 3 of Part Two of this report relating to co-insurance.

9. Id., at p. 14.

10. Id., at p. 22.

11. Id., at p. 21.

12. Id.

13. Id., at p.20.

14. Id., at p.24.

15. Id., at p.25.

16. Id., at p.27.

17. Kemp, Hearings, May 16, 1990 at p. 39.

18. Department of Housing and Urban Development, "Report on Compliance with the Federal Managers Financial Integrity Act," Dec. 29, 1989, Enclosure 1.

19. Department of Housing and Urban Development, "The Secretary's Semiannual Report to the Congress," No. 2 (for the six month period October 1, 1989 through March 31, 1990) at p. 9.

20. Id., at pp. 10-13.

21. Department of Housing and Urban Development, "The Secretary's Semiannual Report to the Congress," No. 1 (for the six month period April 1, 1989 through Sept. 30, 1989) at p. 19.

22. Id.

23. Id.

24. Id., at p.20. Alfred DelliBovi, Under Secretary of HUD, Testimony, Hearings, Vol. 2, June 29, 1990, at pp. 685-686.

25. Department of Housing and Urban Development, "The Secretary's Semiannual Report to the Congress," No. 1 (for the six month period April 1, 1989 through Sept. 30, 1989) at p. 21.

26. Id., at p.11.

27. Id., at p. 18.

28. List of Internal Studies Being Conducted at HUD, Jan. 1, 1990 to July 6, 1990, provided to the Subcommittee by the Office of Congressional Relations, HUD.

CHAPTER TWO
CONGRESSIONAL HEARINGS

The congressional investigation into mismanagement of HUD and its programs during the Pierce Administration has been extensive. While some hearings by other committees and subcommittees have been held, the principal investigation has been conducted by this Subcommittee, the Senate Committee on Banking, Housing and Urban Affairs, and the House Committee on Government Operations, Subcommittee on Employment and Housing. The following is a brief summary of those hearings:

I. HUD/Mod Rehab Investigation Subcommittee

January 30, 1990 -- Mission of HUD

Witnesses:

Robert Weaver, former Secretary of HUD
Robert Wood, former Secretary of HUD
John Rhinelander, former Under Secretary of HUD
Richard van Dusen, former Under Secretary of HUD
Philip Brownstein, former Housing Commissioner
Anthony Downs, The Brookings Institution
Rudolph Penner, The Urban Institute

Summary: The first panel, composed of former top HUD officials reviewed the mission of HUD, how it had changed, and placed the current scandals in their historic perspective. The second panel generally reviewed the scandals, HUD programs, capacity, and oversight.

February 27, 1990 -- Anatomy of a Deal

Witnesses:

Richard Baron, McCormack Baron & Associates
Thomas Costello, McCormack Baron & Associates
Philip Abrams, Phillips Development
J. Michael Queenan, J. Michael Queenan Associates, Inc.
Tom Cole, Benton Mortgage Company
William Tanker, Benton mortgage Company
William Cottrell, Executive Director, Clark County Housing Authority, Clark County, NV
John Ols, Director of Economic and Community Development Issues, GAO
Marilyn Malkonian, President, Telesis Corporation
Karen Kollias, Vice President of Community Development Lending Group, American Security Bank
Sheldon Baskin, Attorney

Patrick Clancey, Executive Director, The Community Builders

Summary:

The Subcommittee reviewed the financing of two low income housing projects, the Brewery in St. Louis, MO and Sierra Point in Las Vegas, NV to examine issues of subsidy layering and the amount of subsidy necessary to induce private development of low income housing. The subcommittee learned that developers had taken advantage of subsidy layering and that tax credits were not always the most productive use of federal housing funds. Experts told the Subcommittee that Congress should not attempt to delineate a rate of return for developers. The Mod Rehab program changed from its original design as a program providing limited per unit funding to one funding substantial per unit rehabilitation costs.

March 27, 1990 -- Co-insurance

Witnesses:

Larry Dale, Senior Vice President, Multifamily Finance and Housing Initiatives, GNMA
George Hipps, Senior Vice President, PW Funding, Inc.
Thomas Craren, Partner, Price Waterhouse
Alfred DelliBovi, Under Secretary of HUD
Peter Monroe, General Deputy Assistant Secretary of Housing, HUD
Robert Kalish, Executive Vice President, GNMA
John Baecker, former President and Chief Underwriter, United Guaranty Commercial Insurance Company
Robert Edelstein, Professor, Center for Real Estate and Urban Economics, University of California at Berkeley
Chris Greer, Assistant Inspector General for Audit, HUD
Warren Lasko, Executive Vice President, Mortgage Bankers Association
Gaye Beasley, Member, Board of Directors, Mortgage Bankers Association

Summary:

The Subcommittee held a roundtable discussion of a variety of co-insurance issues, including design and implementation flaws and intended HUD action in replacing co-insurance with a designated underwriting program. Among the design flaws discussed were inadequate loan quality controls and capital requirements for participating lenders; inadequate default remedies; and over-exposure of the federal government to risk. The implementation flaws included concentration of risk in a few lenders and inadequate monitoring by HUD.

April 18, 1990 -- HUD Management

Witnesses:

Paul Adams, Inspector General, HUD
Chris Greer, Assistant Inspector General for Audit, HUD
James Martin, Director of Planning and Administration, Office of Inspector General, HUD
Alfred DelliBovi, Under Secretary of HUD
Harold Henry, Director, Office of Management and Quality Assurance, HUD
Janice Combs, Director, Financial Management Systems, Office of Finance and Accounting, HUD
Donald Chapin, Assistant Comptroller, Accounting and Financial Management Division, GAO
Jeffrey Steinhoff, Director, Financial Management Issues and Audits
John Ols, Director, Housing and Community Development Issues, GAO

Summary: The Subcommittee reviewed HUD compliance and lack thereof with the Federal Managers Financial Integrity Act regarding material weaknesses in HUD's internal controls and financial management systems during the Pierce Administration.

April 20, 1990 -- Staffing and Capacity

Witnesses:

Walter Sevier, Deputy Regional Administrator, Fort Worth Regional Office, HUD
Alfred Kliman, Director, Office of Budget, HUD
George Hipps, Vice President, PW Funding Mortgage Company
Marvin Siflinger, Executive Director, Massachusetts State Housing Finance Agency (representing National Council of State housing Finance
Agencies)
Daniel Grady, President, The Monfric Corporation (representing National Assisted Housing Management Association)

John Koelemij, President, Orange State Construction Company (representing National Association of Home Builders)
Brian Chappelle, Staff Vice President for Residential Finance/Government Agency Relations, Mortgage Bankers Association
Dwight Ink, President, Institute for Public Administration

Summary: The Subcommittee reviewed the reduction of staffing levels during the Pierce Administration and its impact on the ability of HUD to perform its duties. Also reviewed were issues regarding training and the relationship of political and career employees.

April 23, 1990 -- Executive Oversight

Witnesses:
Anne Banning, former Assistant Director, Office of Presidential Personnel (OPP)
Charles Dutcher, former Assistant Director, OPP
Mark Robbins, former deputy Assistant Director, OPP
William Diefenderfer, Deputy Director, OMB
Frank Hodsell, Executive Associate Director for Management, OMB
Hugh Heclo, Professor, George Mason University
Alan Dean, former Deputy Associate Director, OMB
Harold Seidman, former Assistant Director for Management and Organization, Bureau of the Budget

Summary: The Subcommittee reviewed the role of the Office of Presidential Personnel in the placement of political personnel at HUD and the role of OMB in its oversight of HUD. In particular, the Subcommittee examined the assistance OMB and GAO provide HUD regarding management issues.

April 27, 1990 -- Low Income Housing Tax Credit

Witnesses:
John Ols, Director, Housing and Community Development Issues, GAO
John Weicher, Assistant Secretary for Policy Development and Research, HUD
James Logue, Deputy Assistant Secretary for Multifamily Housing
David Blattner, Assistant Commissioner for Examination, Internal Revenue Service

Mark Hendrickson, Executive Director, Florida Housing Finance Agency, (representing the National Council of State Housing Agencies)
Barton Harvey III, Deputy Chairman, the Enterprise Foundation
William Haynsworth, Senior Vice President, the Boston Financial Group, Inc.

Summary: The Subcommittee conducted a roundtable discussion of issues involving the tax credit, including the timing of credit allocation actions of state housing credit agencies relative to the timing of HUD and Farmers Home Administration awards of non-tax subsidies; the need for expeditious action by HUD in implementing its new responsibilities; the need for longer term extension of the tax credit; and the need for clarification of the responsibility of the state housing credit agencies in monitoring the tax credit.

May 8, 1990 -- Congressional Oversight

Witnesses:
Paul Adams, Inspector General, HUD
Charles Dempsey, former Inspector General, HUD
Frederick Kaiser, Specialist in American National Government, Congressional Research Service
Richard Fogel, Assistant Comptroller General, GAO
Stanley Brand, Brand & Lowell
Richard Wegman, Garvey, Schubert & Barer (representing the National Academy of Public Administrators)
Thomas Mann, Director, Government Studies program, the Brookings Institution
Bert Rockman, Senior Fellow, Government studies Program, the Brookings Institution

Summary: The Subcommittee discussed the warnings given Congress by the HUD Inspectors General and GAO. The Subcommittee also discussed the appropriate role of Congress in conducting oversight of HUD.

May 16, 1990 -- Rebuilding of HUD

Witnesses: **Jack Kemp**, Secretary of HUD

Summary: The Subcommittee invited Secretary Kemp to share his actions taken in response to the HUD scandals, his plans for the agency and his view of its mission.

June 29, 1990 -- Receipt of Semiannual Reports/Criminal Investigations

Witnesses:
Paul Adams, Inspector General, HUD
Alfred DelliBovi, Under Secretary od HUD
Paul Maloney, Deputy Assistant Attorney General, Criminal Division, Department of Justice
John Keeney, Deputy Assistant Attorney General, Criminal Division, Department of Justice
Frank Keating, General Counsel, HUD

Summary: The Subcommittee received the latest semiannual report of the Inspector General and of the Secretary and reviewed the current status of criminal investigations involving HUD.

II. Senate Committee on Banking, Housing and Urban Affairs

May 17, 1989

Witnesses:
Paul Adams, HUD Inspector General
Edward Brooke, former U.S. Senator
Richard Shelby, former consultant
Judith Siegel, President, Landex, Corp.
Frederick Bush, former consultant

Summary: Adams testified regarding abuses, mismanagement and favoritism in the Section 8 Moderate Rehabilitation Program.

August 2, 1989

Witnesses: **Donald Terner**, President, Bridge Housing Corp., San
Francisco, CA
Judy Truitt, Chief, Housing Assistance Division,
Jacksonville, FL
John Ols, Director of Housing and Community Development Issues, Resources, GAO
Paul Adams, HUD Inspector General
Morton Schussheim, Senior Specialist in Housing, CRS

Summary: The committee conducted a panel discussion of a variety of issues arising from the May hearing, including the calculation of fair market rents, co-insurance, low income housing tax credit, and the use of consultants.

September 18, 1989

Witnesses: **Melvin Adams**, Executive Director/Director of Housing Opportunities Commission of Montgomery County, Kensington, MD
John Weicher, Assistant Secretary of Housing and Urban Development, HUD
James Logue, Deputy Assistant Secretary for Multifamily Housing, HUD

Summary: The committee began a series of three hearings on abuses in the Mod Rehab program by focusing on the calculation of fair market rents.

September 28, 1989

Witnesses: **Paul Adams**, HUD Inspector General
Peter Monroe, consultant
Walter Sevier, Deputy regional Administrator, Fort Worth Regional Office, HUD
James Logue, HUD
Gaye Beasley, President, Partcian Mortgage Co., representing Mortgage Bankers Association of America

Summary: The Committee focused on co-insurance. Adams testified to inappropriate lender practices that cause inflated mortgages and to lack of aggressive servicing of loans that led to higher default rates. In particular, Adams discussed the high default rate of DRG Funding Corp. and deficiencies in the practices of Benton Mortgage Co. Among the problems noted was delegation of authority of HUD, including the establishment of section 8 rental rates, without adequate monitoring. Other problems discussed was the fact that the federal government actually assumed all the risk rather than sharing it with the lender. An example of an inflated mortgage was the $47.2 million mortgage for Colonial House in Texas, which sold for only $8.9 million after default. GAO estimated the losses under the co-insurance program at $960 million.

September 29, 1989

Witnesses: **John Ols**, GAO
Trudy McFall, Executive Director, Maryland Community Development Administration

Benson Roberts, Special Assistant for Policy and Program Development, Local Initiatives Support Corp.

Summary: The Committee focused upon abuses involving the low income housing tax credit. Representatives of GAO testified that the lack of centralized review of the various subsidy mechanisms for a project, including the tax credit, allowed developers to realize windfall profits. The tax credit and Mod Rehab programs work well in tight rental markets, but, GAO believes that tenant-based certificates and vouchers are more efficient in soft markets.

October 31, 1989

Witnesses:
William Diefenderfer, III, Deputy Director, OMB
Richard Davis, Former Associate Director for Cabinet Affairs, the White House
Carol Crawford, Former Associate Director for Economics and Government, OMB

Summary: The Committee focused upon the oversight responsibilities of OMB and the white house as the relate to HUD. The management staff at OMB was sharply reduced during the 1980s limiting its effectiveness at assisting agencies and monitoring their management. There was no follow up at OMB of problems noted in reports of agency inspectors general. Crawford told the committee that the budget side did not concern itself with HUD IG reports because they were management related. OMB tried to zero budget the Mod Rehab program.

III. House Subcommittee on Employment and Housing

May 8, 1989

Witnesses:
Paul Adams, HUD Inspector General
Thomas Demery, former Assistant Secretary for Housing, HUD
Angus Olson, Executive Director of the Alexandria Redevelopment and Housing Authority, Alexandria, VA

Summary: The Subcommittee heard Adams testify to abuses, favoritism and mismanagement of the Section 8 Moderate Rehabilitation program, including instances of developers using consultants to receive funding and the absence of controls and evaluative criteria.

May 25, 1989

Witnesses:

Judith Siegel, President, Landex Corp.
Samuel Pierce, former Secretary of HUD
Frederick Bush, former consultant
John Knapp, HUD General Counsel (5/81-9/86)
J. Michael Dorsey, HUD General Counsel (3/87-2/89)

Summary:

The Subcommittee focused upon the use of consultants by developers to obtain units under the Mod Rehab program. Siegel testified that she retained James Watt, as a business partner, to help secure funding for a 300-unit project in Maryland. Watt was retained because he had access to Pierce, not because he had any housing background. Pierce testified that he never directed that any project be funded.

June 9, 1989

Witness:

James Watt, former Secretary of the Interior

Summary:

The Subcommittee invited Watt to explain his role as consultant in the awarding of Mod Rehab funds. He testified that he had made a few telephone calls and had met with Pierce. He blamed career staff for problems with the program and found it best to deal directly with Pierce. He received $300,000 (which he split with others) for his successful efforts but insisted that he was paid out of funds of the developer and not with federal funds. He also met with Dean, Barksdale and Debartolomeis.

June 13, 1989

Witnesses:

Silvio DeBartolomeis, former General Deputy Secretary, HUD
Deborah Gore Dean, former Executive Assistant to Secretary of HUD

Summary:

The Subcommittee continued to focus on the Mod Rehab funding process. DeBartolomeis testified that the process evolved into a political program when funding was cut and that career staff were not involved in the process. He stated that Dean was the final decision-maker. He also said that he never on the Mod Rehab selection committee, even though

Dean had said that he, Janet Hale, Shirley Wiseman, and John Knapp had participated in the committee. Dean refused to testify, citing her rights under the Fifth Amendment to the U.S. Constitution.

June 16, 1989

Witnesses:

Paul Adams, HUD Inspector General
Marilyn Louise Harrell, former settlement agent for HUD

Summary:

The Subcommittee focused on allegations of fraud and embezzlement in the Single family Property Disposition program. Adams testified that HUD had privatized the program by contracting with escrow or settlement agents to handle closings for the sale of defaulted properties under the program and transmit the sale proceeds to the Treasury. The agents were paid a fee. The subcommittee learned that the agents were not bonded or properly screened and trained. After they were under contract, HUD also failed to carefully monitor there performance and, as a result, there were instances in which agents embezzled funds from the proceeds of sales. An example was Harrell, who stole $5.5 million. She admitted this the Subcommittee and testified that she gave much of it to charity, for which she became nicknamed "Robin HUD."

June 20, 1989

Witnesses:

Bruce Peterson, Mayor, Township of Upper Deerfield, Cumberland County, NJ
Paul Manafort, Black, Manafort, Stone, and Kelly

Summary:

The Subcommittee focused upon the Seabrook project in Deerfield, NJ. Peterson testified that the township was not consulted regarding the rehabilitation of the project and would have preferred to have the federal dollars spent differently. Consultant fee for 326 unit project was $326,000. Manafort role was influence peddling.

June 22, 1989

Witnesses:

Joseph Strauss, former Special Assistant to the Secretary of HUD
Philip Abrams, former Under Secretary of HUD
Phillip Winn, former Assistant Secretary of HUD

Summary: The Subcommittee focused upon three former HUD officials who left the agency and engaged in the development of low income housing. Strauss testified to retaining James Watt to influence HUD decisions under the Mod Rehab program and that the program was developer driven. Abrams testified to directly contacting Dean regarding funding of projects. Winn testified to number of Mod Rehab projects he and his group were able to obtain funding for but denied any wrongdoing.

June 29, 1989

Witnesses:
Hunter Cushing, former Deputy Assistant Secretary for Multifamily Housing, HUD
Frederick Bush, former consultant
William Connolly, Director of Housing, NJ

Summary: The Subcommittee focused upon Bush's ability to get a Technical Assistance Grant associated with a CDBG grant for San Juan, Puerto Rico and his relationship with Dean and Hunter Cushing. Bush received the grant over the objections of career staff and lacked qualifications to do the work funded. Cushing did not testify, requesting more time to prepare.

June 30, 1989

Witnesses:
Paul Adams, HUD Inspector General
George Hipps, Jr., Senior Vice president, P.W. Funding, Inc.
Thomas Demery, former Assistant Secretary of Housing

Summary: The subcommittee focused upon the multifamily co-insurance program. Adams testified to program abuses resulting in substantial losses from defaults, primarily from a few co-insurers, including DRG Funding Corp. Among the abuses cited were over-appraisals of properties and poor underwriting and loan servicing by participating lenders. Hipps testified to the program as a representative of the Mortgage Bankers Association. Demery also testified to problems with the program.

July 11, 1989

Witness: **Jack Kemp**, Secretary of HUD

Summary: Kemp testified to discussions with the HUD IG regarding problems at HUD. Kemp reacted by cancelling Mod Rehab funding approvals and then reopening the program on competitive basis; beginning study of co-insurance program and suspending DRG Funding Corp.; proposing termination of Title X program because of default rate and lack of benefit to low income persons; and cancellation of Retirement Service Center program for same reasons. Kemp puts the cost of the HUD scandals between $1 and $6 billion.

July 14, 1989

Witnesses:
Shirley Wiseman, former General Deputy Assistant Secretary for Housing and Acting Housing Commissioner, HUD
Janet Hale, former General Deputy Assistant Secretary for Housing, HUD

Summary: Wiseman testified that regarding a Durham Hosiery project in North Carolina which Pierce and Dean directed her to fund despite the objections of career staff regarding the cost of the project and a number of serious problems that required extensive waivers. Wiseman refused to sign the funding documents. Hale replaced Wiseman and also testified to being told by Dean that Pierce wanted the project funded and that Pierce had already signed them, awaiting her signature. Wiseman also testified regarding the suspension of DRG Funding Corp. as a co-insurer by Barksdale for poor underwriting practices. Wiseman rejected DRG's request to lift the per-commitment approval requirement. After Pierce met with Carla Hills, representing DRG, Pierce lifted the suspension and the requirement.

July 24, 1989

Witnesses:
William Taylor, consultant
Lynda Murphy, former HUD employee

Summary: The Subcommittee continued its exploration into the use of consultants and influence peddling. Taylor testified to using Republican National Committee stationery in his correspondence with Dean and other HUD officials and that it was known that Dean was the person to contact to get units for clients. Murphy was a former HUD employee who befriended Dean. Murphy was able to see HUD document relating to DRG while neither HUD employee or DRG representative (though a client was affected by it). Murphy hired Dean as a consultant after Dean left HUD.

July 28, 1989

Witness: **Joseph Monticciolo**, former Director, New York Regional Office, HUD

Summary: Monticciolo testified that the Mod Rehab program was operated on political basis and that Dean exerted "tremendous influence" often representing Pierce. Mod Rehab units were often awarded without any input from Regional Offices.

July 31, 1989

Witnesses: **William Proxmire**, former Senator
Maurice Barksdale, former Assistant Secretary for Housing, HUD
John Knapp, former General Counsel, HUD

Summary: Proxmire told the subcommittee that Congress had not been conducting adequate oversight and had missed the problems at HUD. Barksdale testified regarding the Colonial House project in Texas. He objected to funding the project because of improper practices of the co-insuring lender, DRG Funding Corp. and concern that the market could not support the project. Barksdale also testified that he was involved in a number of projects receiving HUD funding after leaving HUD. Knapp returned to testify that he had not made an oral opinion to Pierce regarding the allocation of Mod Rehab units after the fair share requirement had been repealed.

September 26, 1989

Witness: **Samuel Pierce**, former Secretary of HUD

Summary: Pierce refused to testify, citing his rights under the Fifth and Sixth Amendments to the U.S. Constitution.

September 27, 1989

Witnesses: **Lance Wilson**, former Executive Assistant to the Secretary of HUD

Alexander Naclerio, former Director of Housing, New York Office, HUD
Donald Morron, Chief Executive Officer, Painewebber
Dick Eudaley, former Deputy Regional Administrator, Fort Worth Office, HUD
Walter Sevier, former Deputy Regional Administrator, Fort Worth Office, HUD

Summary: Wilson refused to testify, citing his rights under the Fifth Amendment to the U.S. Constitution. Naclerio testified to paying Wilson for assistance in getting action on HUD projects after both he and Wilson were no longer working at HUD. Marron CHECK SPELLING testified to Wilson's involvement with HUD after becoming an official with the company, some of which was against company policy. Eudaley testified to influence Wilson exercised in getting UDAG funding for a project from HUD over the objections of career staff. Sevier testified to a number of UDAG projects funded by HUD over the objections of the field office. He also testified to objecting to funding for Colonial House but was told that it had to be funded because DRG had committed HUD under the co-insurance program.

October 2, 1989

Witnesses:
Paul Manafort, Black, Manafort, Stone and Kelly
Laurance Gay, Black, Manafort, Stone and Kelly
Richard Davis, Black, Manafort, Stone and Kelly
Victor Cruse, CFM Development Corp.

Summary: The subcommittee continued its investigation of influence peddling and the use of consultants. One project investigated was the Seabrook NJ project whereby Manafort, as consultant, approached the local PHA to apply for 326 Mod Rehab units, which coincided with the needs of the seabrook project. The project received funding approval in about a month.

October 13, 1989

Witnesses:
J. Michael Queenan, former Director of Housing Development, Denver Regional Office, HUD
Gerald Carmen, former Administrator of the General Services Administration

Summary: Carmen was a developer of the Pebble Creek project in Texas. Queenan was involved with a number of HUD-assisted projects after leaving HUD, including an association with other former HUD officials, Philip Abrams, Phillip Winn, and Lance Wilson (called the Winn Group by the HUD IG) in five HUD-assisted projects. The group was successful in getting units for 6 of 7 projects. According to the HUD IG, Queenan had a role in obtaining almost 3,000 Mod Rehab units and the Winn Group, about 1,300 units. Queenan testified to the role of the various partners in the group. Carmen was involved with Queenan as the developer of the Pebble Creek project in Texas after serving as Ambassador to UN in 1984. Carmen met with Pierce seeking approval for Mod Rehab units for Arlington, Texas. Documents showed that 316 units were approved for Arlington before it had even applied for them.

October 27, 1989

Witness: **Samuel Pierce**, former Secretary of HUD

Summary: Pierce refused to testify, citing his rights under the Fifth Amendment to the U.S. Constitution.

February 5, 1990

Witnesses: **Carol Crawford**, former Associate Director for Economics and Government, OMB
James Hamernick, former director, HUD Office of Insured Multifamily Housing Development

Summary: Crawford, who was responsible for HUD's budget at OMB, testified that OMB is a policy and budget entity and that she was unaware of the extent of problems at HUD during her tenure between 1985-1989. In response to problems with Mod Rehab program, OMB zeroed-out the program's budget. She also testified that OMB was moving away from housing construction programs and into vouchers. Hamernick refused to testify, citing his rights under the Fifth Amendment to the U.S. Constitution.

February 6, 1990

Witnesses: **Paul Adams**, HUD Inspector General
Paul Kane, Regional Inspector General, Region 2, HUD

Michael Janis, General Deputy Assistant Secretary for Public and Indian Housing, HUD
Frank Keating, General Counsel, HUD

Summary: The Subcommittee focused upon abuses in the PHA Decontrol Program at HUD which had been reported by the HUD IG. Under the program, qualifying public housing authorities received greatly reduced supervision by HUD. The IG found that the officers of the Passaic PHA were engaging in fraud, including the collection of multiple salaries and that HUD had mismanaged the program and had placed some PHAs in the program against their wishes. Other improprieties were also noted, including the non-competitive procurement of legal services. Keating testified to administrative actions taken against the authority.

March 9, 1990

Witnesses:
Joseph Lipari, Mayor of Passaic, NJ
Margie Semler, Passaic Councilwoman
Marcia Young, Member and former Secretary, Passaic PHA Tenants' Association Council
Peter Morrocco, Passaic Housing Authority Commission
William Scruggs, former Vice Chairman, Passaic PHA Commission
Joseph Giordano, former commissioner, Passaic PHA Commission
Arthur Glover, former commissioner, Passaic PHA Commission
Frank Scancarella, former commissioner, Passaic PHA Commission
August Michaelis, former Passaic PHA Attorney
Paul Marguglio, former Passaic PHA Executive Director
Donald Pieri, former Deputy Executive Director, Passaic PHA
Louise Marguglio, former PHA Director of Administration, Passaic PHA

Summary: The subcommittee continued its examination of abuses at the Passaic, NJ public housing authority. Various officials testified that they were either unaware of the abuses or were duped by the PHA Executive Director. Paul and Louise Marguglio and Donald Pieri refused to testify, citing their rights under the Fifth Amendment to the U.S. Constitution.

April 30, 1990

Witness: **Dubois Gilliam**, former Deputy Assistant Secretary, HUD

Summary: Gilliam testified under a grant of immunity and was at the time serving an 18-month sentence for illegal receipt of funds and for defrauding the government. The focus of testimony was on the Urban Development Action Grant (UDAG) program. Gilliam testified to a number of program abuses, including the manipulation of funding levels to assist a project supported by Lance Wilson. Gilliam also testified regarding the transfer of a HUD career employee who questioned certain practices involved in the UDAG program.

May 2, 1990

Witness: **Dubois Gilliam**, former Deputy Assistant Secretary, HUD

Summary: The Subcommittee focused upon the Special Projects Program and the Mod Rehab program. Gilliam testified that the Special Projects program was operated as a political program. On one occasion, Pierce directed him to provide a $300,000 grant for repairs for a college in Mississippi as a favor to a friend who was on the board of trustees. Because the program required the funds to be paid to a state or local government, HUD asked the mayor of a nearby city to act as intermediary, which it did after the award was increased to $350,000 with the additional funding going to the city. Gilliam also testified to participating in a Mod Rehab funding committee meeting at which funds were awarded by Dean, Demery, and Dorsey based on political considerations. Gilliam also testified that Pierce promised him 250 Mod Rehab units after leaving HUD as a severance package worth over $1.5 million.

May 4, 1990

Witness: **Dubois Gilliam**, former Deputy Assistant Secretary, HUD

Summary: The subcommittee focused upon abuses in the Technical assistance Program funded out of the Secretary's Discretionary Fund. Gilliam testified that this program was also operated in a political manner, including instances in which Pierce directed him to allocate funds to friends. In one instance, Gilliam traveled to New Jersey to convince the affected mayor of HUD's desire to allocate technical assistance funding for the city to a specific company.

May 23, 1990

Witnesses: **Thomas Demery**, former Assistant Secretary for Housing, HUD
Gerald Kisner, former Deputy General Counsel, HUD

Summary: Demery returned to the subcommittee to testify that HUD was operated like a political machine. After Demery told Pierce of his concerns with the way the Mod Rehab program was run, Pierce told him that Demery, Dean and Cushing would meet to fund projects and that Dean would speak for Pierce. Kisner testified regarding his work as a consultant after leaving HUD helping developers obtain Mod Rehab funding.

June 21, 1990

Witnesses: **Leonard Briscoe**, Florida developer
Jeffrey Auslander, Florida real estate developer
Elliot Richardson, representing the Volker Commission

Summary: Briscoe refused to testify, citing his Fifth Amendment rights. Auslander testified that, as a competitor of Briscoe's he was aware that Briscoe was a friend of Lance Wilson and was able to receive HUD funds for projects. Auslander also testified that the Black, Manafort contacted him offering to help him get Mod Rehab funding for a fee. Richardson testified regarding the findings of the Volker Commission regarding the relationship between political and career employees.

CHAPTER THREE
HUD REFORM LEGISLATION

The new HUD Secretary, Jack Kemp, was forced to deal with an ever growing series of revelation of fraud and mismanagement at his agency. He worked swiftly to correct these abuses after holding a series of meetings with the Inspector General. Congress and the Bush administration joined forces to produce comprehensive reform legislation. Signed into law by the President on December 15, 1989, this legislation, referred to as the HUD Reform Act or H.R. 1,[1] contains sixty detailed sections which deal with a host of varied housing issues. The bulk of these provisions protect the future selection and administration of HUD projects from the types of abuse documented by Congressional hearings. Among the protective features of the Act:[2]

(1) To safeguard HUD spending decisions from abuse, the Act requires that HUD program money be distributed to regions of the country on the basis of need, and then to communities and individual projects through open competition (Section 101). All federal, local and state funding decisions must be publicly announced, and HUD must further reveal in the Federal Register whenever funds are available, documenting the selection criteria for awarding such funds (Section 102). Only certain high-level HUD officials (Assistant Secretaries or those of equivalent rank) can now grant waivers of federal regulations, and any such waivers must be justified in writing and published in the Federal Register (Section 106). The legislation further restricts the discretion for top HUD officials to award projects from money available in the Headquarters Reserve and in the Secretary's Discretionary Fund (Sections 104 and 105, respectively);

(2) To ensure public scrutiny of all applicants for HUD projects, the Act mandates that such applicants disclose the names of all parties with financial interests in the immediate project (Section 102). They must also reveal any fees and other expenditures paid to individuals for the purpose of influencing a decision of any employee of HUD regarding the award of a project or the change of any terms and conditions in a current project (Section 112). Lobbyists or others receiving such fees or expenditures must independently register with HUD within 14 days after being retained, and their registration papers must disclose whether they have worked for the federal government in the past two years (Section 112). Fees based on the amount of subsidy obtained are prohibited unless services are being performed for a non-profit entity. (Section 112);

(3) To provide for effective monitoring of HUD programs and collection and dissemination of financial data, the Act establishes a Chief Financial Officer at HUD and a comptroller for the FHA fund (Sections 121 and 122, respectively). In addition, it authorizes $25 million in 1991 for evaluation of a hodgepodge of HUD programs: specifically, those authorized under titles I and II of the U.S. Housing Act of 1937, section 202 of the Housing Act of 1959, section 106 of the Housing and Urban Development Act of 1968, the Fair Housing Act, title I and section 810 of the Housing and Community Development Act of 1974, section 201 of the Housing and Community Development Amendments of 1978, the Congregate Housing Services Act of 1978, section 222 of the Housing and Urban-Rural Recovery Act of 1983, section 561 of the Housing and Community Development Act of 1987, and title IV of the Stewart B. McKinney Homeless Assistance Act (Section 124). The Secretary must spend the authorized amount "in accordance with the need and complexity of evaluating and monitoring each such program," and, as HUD's monitoring progresses, must "determine any need for additional staff and funding..." (Section 124).

(4) To address problems in HUD's Co-insurance and Section 8 Moderate Rehabilitation programs, they were singled-out as programs requiring more specific monitoring and greater restrictions. The Act mandates that HUD review semi-annually the adequacy of its "capital and other requirements" imposed upon co-insurance lenders and the extent that such lenders are complying with these requirements (Section 139). These "capital and other requirements" include specifically the minimum net worth of the lenders, the minimum ratio between net worth and the volume of co-insured mortgages, and "such other requirements as the Secretary determines to be appropriate to ensure the long-term financial soundness" of the FHA fund (Section 139). Any of these requirements may be changed by HUD, after an opportunity for a hearing, if HUD determines that doing so would improve the "long-term financial soundness" of the FHA fund (Section 139). The Act also directs HUD to issue a report on the disposition of co-insured multi-family housing projects held by GNMA, describing each property and revealing the guidelines governing the disposal of such properties (Section 139). As to the Mod Rehab program, H.R. 1 requires a minimum expenditure of $3,000 per unit for those receiving Mod Rehab funds (Section 127). HUD must now limit Mod Rehab awards to projects with less than 100 units, must allocate funds on a needs-based competition, and must, when determining the amount of assistance to a project, consider the extent to which tax credits will be available (Section 127).

(5) To further address the need for effective monitoring, a number of provisions increase FHA monitoring by requiring annual financial statements and independent audits (Section 131), establishing a new FHA advisory board (Section 142), expanding the monitoring and enforcement power of HUD's Mortgagee Review Board (Section 142), and requiring HUD to set appraisal standards for properties with FHA mortgages (Section 142). Also, HUD's Title X Land Development program is abolished by the reform package. (Section 133).

(6) To allow for better enforcement of HUD rules, the Act gives HUD, for the first time, direct legal authority to impose civil penalties in a variety of situations where an individual, entity, or HUD employee violate certain provisions of the Act or existing HUD regulations (Sections 102, 103, 107, 108, 109, 110, 111, 112, 126, 134, and 536). HUD now has authority to assess civil penalties for, among other things, any failure by an individual or entity to disclose information required by law or regulations and any unauthorized disclosure by a HUD employee of project selection information. In addition, again for the first time, the HUD-controlled Mortgagee Review Board has been given authority to issue cease and desist orders where the Board has "reasonable cause" to believe that a mortgagee "is violating, has violated, or is about to violate, a law, rule or regulation or any condition imposed in writing by the Secretary or the Board" and such violation could result in "significant cost" to the federal government (Section 142).

ENDNOTES

1. Department of Housing and Urban Development Reform Act of 1989, P.L. 101-235, 103 Stat. 1987 (December 15, 1989).

2. For a summary of the provisions of H.R. 1 see "HUD 'Reform' Package Ready For Bush Signature," Congressional Quarterly, Volume 47, pp. 3409-3410, December 9, 1990.

CHAPTER FOUR
APPOINTMENT OF INDEPENDENT PROSECUTOR

On both September 26, 1989 and October 27, 1989, former Secretary Pierce invoked the Fifth Amendment at hearings before the House Subcommittee on Employment and Housing.[1] After each hearing, Rep. Charles Schumer (D-NY) and Rep. Bruce Morrison (D-CN), two members of the House Committee on Banking, Finance and Urban Affairs, Subcommittee on Housing and Community Development, attending the hearings, called publicly for the Justice Department to request appointment of an independent prosecutor to investigate the subcommittee's revelations of abuse at HUD.[2]

On November 2, 1989, nineteen members of the House Committee on the Judiciary, led by Schumer and Morrison, wrote Attorney General Dick Thornburgh requesting that the Justice Department appoint an independent prosecutor to investigate possible criminal acts by Pierce and "other high-level officials of HUD." The letter asks that the independent counsel's jurisdiction include authority to determine whether Pierce and other high-level officials may have committed perjury.[3]

Attorney General Thornburgh announced in a letter dated December 4, 1989 to Rep. Jack Brooks (D-TX), Chairman of the House Committee on the Judiciary, that he would, as required by statute,[4] conduct an inquiry to determine whether an independent counsel should be appointed, and, as further required by statute, make such a determination within 90 days.[5]

On February 1, 1990, Thornburgh applied formally to the United States Court of Appeals for the District of Columbia, Special Division, for the appointment of such an independent counsel. Thornburgh refused to recommend that the independent counsel investigate whether perjury had been committed by Pierce and others, and he advocated that the jurisdiction of such an investigation should involve determining only "whether Secretary Pierce and other HUD officials may have committed the crime of conspiracy to defraud the United States or any other crimes relating to the administration of the [Section 8 Moderate Rehabilitation Program] selection process from 1984 through 1988."[6]

After receiving Thornburgh's application, a special three-judge panel consisting of Judges MacKinnon, Butzner and Pell ordered on March 1, 1990 that Arlin Adams, a former judge on the United States Court of Appeals for the 2nd Circuit, be appointed as independent counsel and "given the full power, independent authority and all obligations [as set forth in the relevant independent counsel statute]" to investigate "whether [Pierce] and other [HUD] officials may have committed the crime of conspiracy to defraud the United States or any other Federal crimes (other than those classified as Class B and C misdemeanors or infractions) relating to the administration of the selection process of [HUD's Section 8 Moderate Rehabilitation Program] from 1984 through 1988 inclusive." Adams was also given authority to make any prosecutions which stem from such an investigation.[7]

On May 25, 1990, in response to the immunized testimony of Dubois Gilliam, a former top aide of Pierce who appeared before the House Subcommittee on Employment and Housing during three days of hearings, Thornburgh referred additional investigative matters to Adams and requested that he add them to the established mandate. Specifically, Thornburgh stated that Adams should expand the investigation to include "the administration of the selection process of HUD's Urban Development Action Grant program and the programs within the Secretary's Discretionary Fund (Technical Assistance and Special Projects)."[8]

Soon after receiving the referral from Thornburgh, Adams notified the three-judge panel that he would accept the expanded jurisdiction, and the panel issued an Order Expanding Jurisdiction on July 16, 1990. Adams' jurisdiction was expanded to include investigation of:

> "the administration of: (1) [HUD's] Moderate Rehabilitation Program, (2) the Department's Urban Development Action Grant Program, and (3) the programs within the Secretary's Discretionary Fund (Technical Assistance and Special Projects) (herein, "the programs"), and whether [Pierce] and other officials of [HUD] and other persons and entities, from 1984 through 1988 inclusive, may have committed the crime of conspiracy to defraud the United States, or any other federal crimes, including aiding and abetting, (other than those classified as Class B or C misdemeanors or infractions) relating to the above subject matters...."[9]

On July 24, 1990, all eight members of the House Subcommittee on Employment and Housing, in a 27-page letter to Adams, stated that after a careful review of the record for the subcommittee's 120 hours of hearings, they urge Adams to further expand his jurisdiction into the following three areas:

> "(1) whether [Pierce] committed perjury...before the subcommittee on May 25, 1989; (2) the relationship between [Pierce], his former law firm, Battle, Fowler, Jaffin and Kheel, and Lance Wilson, and whether through their actions and dealings the Federal conspiracy statute, bribery statute, conflict of interest law or any other criminal law was violated; and (3) whether [Pierce] and other HUD officials conspired to defraud the United States or committed any other crimes in connection with the administration of the Co-insurance Program from 1983 to 1989."[10]

ENDNOTES

1. Samuel Pierce, former Secretary of HUD, Testimony, House Hearings, September 26, 1989 and October 27, 1989.

2. Congressional Quarterly, "Pierce Cites Fifth Amendment at House Panel Hearing," September 30, 1989, p. 2557; Congressional Quarterly, "Pierce Again Cites Fifth Amendment," October 28, 189, p. 2874.

3. Letter, Schumer et al, Committee on the Judiciary, to Richard L. Thornburgh, Attorney General, November 2, 1989.

4. 28 U.S.C. 592.

5. Letter from Dick Thornburgh to Rep. Jack Brooks, December 4, 1989.

6. Application to the Court, Dick Thornburgh, Attorney General before the United States Court of Appeals for the District of Columbia Circuit, Special Division, No. 89-5, February 1, 1990, p. 1, 6, 15.

7. Order Appointing Independent Counsel, United States Court of Appeals for the District of Columbia, Division for the Purpose of Appointing Independent Counsels, March 1, 1990.

8. Letter, Dick Thornburgh, Attorney General, to Arlin Adams, Independent Counsel, May 25, 1990.

9. Order Expanding Jurisdiction, United States Court of Appeals for the District of Columbia, Division for the Purpose of Appointing Independent Counsels, July 16, 1990, p.2, 3.

10. Letter, Lantos et al, House Subcommittee on Employment and Housing, to Arlin Adams, Independent Counsel, July 24, 1990, p.1,2.

APPENDIX

90-332 RC

CRS Report for Congress

The Missions and Management of HUD

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Congressional Research Service • The Library of Congress

THE MISSIONS AND MANAGEMENT OF HUD

SUMMARY

The Department of Housing and Urban Development (HUD) is a troubled agency. Investigations by HUD's Inspector General and congressional committees have disclosed many acts of favoritism and abuse of power. Such activity was especially flagrant in connection with a moderate rehabilitation housing program and a multifamily coinsurance program. But other HUD programs are said to have suffered from weak administration in a period of shrinking budgets and staff.

Factors that have contributed to the difficulties at HUD include lack of agreement about the missions of the agency and the kinds of housing programs required to help low-income people. Deep cuts in program funds and personnel reflected an Administration view that housing programs are less important than macroeconomic policies that raise income levels and enable families to secure housing in the marketplace.

The activation of a multifamily coinsurance program in 1983--part of the general drive to privatize governmental operations--resulted in overvaluation of properties by private mortgage lenders and substantial losses to the Federal Government. Under the now-suspended program, FHA technicians were not permitted to participate in the underwriting of mortgage loans although the Government took the lion's share of the risk.

Another costly oversight by HUD officials was failure to take account of a new tax credit made available in 1986 to developers of low-income housing. Some developers of moderate rehab projects obtained a full subsidy from HUD as well as the tax credit.

Reductions in field personnel have prevented the agency from conducting timely inspections of all FHA-insured and HUD-assisted projects. Thus, there is no assurance that services are being maintained or that subsidy payments are not excessive. There are also gaps in program information and market data. The income and other characteristics of families currently occupying public housing are not known; in setting fair market rents for individual areas, current Census survey data are available only for a small number of areas each year.

Closer oversight in the Congress may help to improve HUD's performance. A number of program and market indicators could be monitored to determine whether changes are needed in housing policies or management.

THE MISSIONS AND MANAGEMENT OF HUD

FAVORITISM, MISMANAGEMENT, THEFT

The Department of Housing and Urban Development (HUD) is a deeply troubled agency. The Department's Inspector General and congressional committees have documented many acts of favoritism, abuse of power, and illegal activity. Politically well-connected consultants and developers, some of whom had previously held high posts in HUD, were able to secure disproportionate amounts of subsidy funds for moderate rehabilitation of housing for the poor. Private mortgage companies were permitted to overvalue properties they were coinsuring with FHA and to get large origination and servicing fees based on these overvaluations. Private escrow agents, paid to dispose of HUD-owned properties, have been charged with failing to remit the sales proceeds to the Government, and one agent has just been sentenced for embezzling more than $5 million from the agency. The misdeeds seemed so egregious that Congress took less than a month to consider and pass a reform package, the Department of Housing and Urban Development Reform Act of 1989 (Public Law 101-235).

Despite this legislation and the efforts of a highly visible and energetic Secretary, the difficulties of the Department are not over. There is a tendency to look for villains as the cause of all problems at HUD, but this focus could deflect a fundamental rethinking of HUD's purposes and management.

LOSING GROUND

HUD's mission is to advance the goal of a decent and affordable home and a suitable living environment for every American family. In fact, the Nation has lost ground since the start of the 1980s. Rents have risen and more tenants are spending burdensome parts of their incomes for shelter. Between 1981 and 1987 the number of renter households rose by 16 percent, but those spending 35 percent or more of income on rent increased from 9.1 million to 11.7 million, a rise of almost 29 percent.

The number of homeless people seems to have swelled, with an increasing proportion thought to be families with children. Young adults and others have had a hard time buying their first home due to high house prices and large down payment requirements. There has been little improvement reported in fair housing practices and patterns, and exclusionary zoning and similar devices continue to keep moderate priced housing and lower income people out of many communities.

WHY THIS PAPER

Recent investigations by several congressional committees, the General Accounting Office, and HUD's Inspector General have made specific findings of abuse and mismanagement in certain HUD programs. This paper is intended to provide an analytic framework within which to consider such findings.

FACTORS CONTRIBUTING TO DIFFICULTIES AT HUD

1. Disagreements about HUD's missions and programs
2. Cuts in HUD funding for programs and personnel
3. Privatization of governmental operations
4. Failure to ask: How much subsidy is enough?
5. Systemic weaknesses in program design
6. Inability to establish or to observe measures of performance

DISAGREEMENTS ABOUT HUD'S MISSIONS AND PROGRAMS

At the heart of the problem is whether the Nation needs and wants significant housing assistance programs. If so, what forms of assistance and levels of funding are desired? The previous Administration took the view that its macroeconomic policies would expand job opportunities and thus reduce the need for low-income housing assistance. Housing advocates were skeptical of this view, and called for a continuation of direct housing subsidies for low-income families.

The Secretary and other high Administration officials recommended the dismantling of low-income housing production programs, arguing that they were too costly and unnecessary in light of an adequate standing stock. They also initiated changes in a rent certificate program to make it operate more like a free market activity (assisted tenants were permitted to pay more than a HUD-approved fair market rent even if this raised their rent-to-income ratio above 30 percent). HUD's leadership also concurred in steep cuts in HUD program funding and staff.

The lack of consensus today is reflected in diverse legislative proposals that have been negotiated into a single Senate bill. Secretary Jack Kemp evidently views HUD as primarily an antipoverty agency; he seeks to turn low-income tenants into homeowners, thereby "empowering the poor." Main elements of the Administration's HOPE bill (S. 2304) have been incorporated in the legislation adopted by the Senate on June 27, 1990; these would promote homeownership by the sale of public housing and HUD-acquired projects to the tenants or other low-income families. The HOPE bill does not attempt to add to the supply of housing available to low-income people. But the measure adopted by the Senate, S. 566, retains a provision to restart assisted housing production through State and local agencies and public-private partnerships.

The House bill, H.R. 1180, would reauthorize several housing production programs and maintain a strong Federal presence in housing.

From the 1940s until the middle 1970s, HUD and its predecessor, the Housing and Home Finance Agency, were viewed as a brick and mortar agency, fostering the production of homes and apartments for middle-, moderate-, and low-income families. The national housing goal--a decent home and a suitable living environment--was expressed as a production target in the Housing Act of 1968: 26 million units to be built or rehabilitated over the following ten years, including 6 million assisted units for lower income people.

Along with its housing responsibilities, the legislation establishing HUD in 1965 (Public Law 89-174) charged it with fostering orderly growth and development of the Nation's communities and metropolitan areas. Prior to 1974, HUD had an active role in urban development through such programs as urban renewal, model cities, sewer and water grants, open space aid, and planning assistance. Such programs were replaced by a community development block grant with passage of the Housing and Community Development Act of 1974 (Public Law 93-383). The objectives of the 1974 law include the elimination and prevention of slums and blighting influences, the expansion and improvement of community services, and more rational utilization of land and other natural resources. But the Department has less direct involvement in such efforts in administering a block grant as compared with categorical aids. In the view of some urban experts, the urban development missions of HUD have been given less attention in recent years than the advocates of a Department hoped for.

The brick and mortar approach is no longer predominant in the assisted housing sector. Most families added to the housing rolls today are being given certificates or vouchers to help pay the rent on apartments already in existence. Housing help from HUD increasingly resembles an income supplement. A number of academics and others have raised the question: Why housing? Why not a cash transfer to the poor? And why HUD? Why not the Department of Health and Human Services (HHS) or another income-support agency?

Housing advocates continue to see the need for housing-linked assistance to the poor rather than straight income support, and for special programs, including new construction or rehabilitation, for first-time homebuyers, homeless persons, the elderly, the disabled, and other disadvantaged groups. While not all advocate groups see eye to eye, most support a compromise of the several major approaches, that is, a combination of tenant-based certificates/vouchers for use in existing housing and project-based subsidies in connection with newly constructed or rehabilitated housing.

A legislative compromise would not lead automatically to markedly improved administration of HUD resources. Nevertheless, the closer the concurrence of housing policy makers in the Congress and the Administration on the objectives and programs included in the legislation, the better the chances for clear directives to departmental staff, understandable guidelines for program participants, and the delivery of housing at acceptable cost to those who need assistance.

The components of the emerging housing package clearly are not the first choice of all parties. The present HUD Secretary is known to feel strongly about the virtue of his homeownership initiatives above traditional approaches. Skeptics say, if ideological preferences become the main basis for rule-making and personnel assignments at HUD, then acceptable administration of the agency's array of programs would be at risk; unfavored programs can become a shambles if neglected by managers and deprived of staff.

Total agreement with every element of an omnibus housing law is not essential to responsible leadership of the Department. Housing Secretary Carla Hills, for example, was opposed to a production approach in the Section 8 program, but once enacted, she got the program under way and is given a good grade for integrity and diligence as HUD Secretary from 1975 until 1977.

CUTS IN PROGRAM FUNDING AND PERSONNEL

Budget authority for HUD was cut sharply--from an average of $27.5 billion a year in the 1977-81 period to less than $9 billion a year from 1986 through 1989 (about $6.5 billion in 1980 dollars). In large part, this decline in budget authority (runout costs) is explained by shifts in program mix to those with lower unit costs and shorter contractual periods (that is, from new construction to existing housing under Section 8), but it also translated into a slowdown in the number of low-income families added to the rolls each year. The number of incremental units slowed from 300,000 families per year in the late 1970s to 100,000 or less in the late 1980s.

Personnel cuts were also deep: HUD's staff was reduced from 15,697 full-time equivalents in 1981 to 12,932 in 1989.

The reductions in HUD personnel undoubtedly had adverse effects on program administration. In the field offices, there were fewer qualified staff to process or monitor projects. There were fewer appraisers to estimate value of properties insured by FHA, fewer engineers to check on quality of construction and maintenance of HUD-assisted projects, fewer FHA loan servicers and HUD housing management specialists to monitor rent collections, vacancies, and management practices. With 50 or more projects per FHA loan servicer, timely and careful monitoring may not have been possible. Anecdotal reports of a serious lowering in morale at the agency are not implausible in light of the steep reductions in force, heavy workloads, and shifts in programs.

PRIVATIZATION

Privatization of governmental operations was a general Reagan Administration goal. One such move at HUD was the 1983 activation of a multifamily coinsurance program, Section 244. Under coinsurance, a private mortgage lender accepts a percentage of the risk of losses due to default on a loan or package of loans and shares in the insurance premiums paid by borrowers. The private mortgage lender also receives a substantial fee for originating the loan and a fee for collecting payments (servicing) on the loan. The private lenders checked credit of the borrowers and placed values on the properties; FHA staff were not involved in these critical underwriting decisions.

Coinsurance proved popular with private lenders, accounting for 70 percent of FHA's new multifamily volume in 1987 and 1988.

The HUD leadership apparently did not anticipate the extent to which private lenders might take undue risks in a coinsurance arrangement where the Government would absorb 80 percent or more of the losses. Problems were quick to arise. One of the largest private lenders, DRG, was found to have mishandled its responsibilities as a coinsurer. A HUD budget document states: "On September 16, 1988, the GNMA declared the DRG Funding Corporation, the second largest consumer lender/issuer, in default on its obligations under the GNMA Mortgage Backed Securities Program and began to take over DRG's portfolio of coinsured mortgages and properties which include 11 properties and 207 mortgage notes with insured face value estimated at over $1 billion . . . [with] an estimated $300 million in defaulted notes." (Congressional Justifications for 1990 Estimates, Part 1, p. H-7, March 1989.)

Secretary Kemp closed down the multifamily coinsurance program on January 17, 1990. HUD's budget justification for 1991 says: "A recent examination of the program revealed it to be structurally flawed and fundamentally unsound as well as administratively unfixable. Claims against the GI [General Insurance] Fund are expected to exceed $1 billion in 1990 and $287.7 million in 1991. Most of the claims are expected to originate from GNMA, which holds a large volume of defaulted coinsured mortgages in mortgage backed security pools which were acquired as a result of issuer defaults." (Congressional Justifications for 1991 Estimates, Part l, p. H-7, February 1990.)

The abrupt termination of the multifamily coinsurance program has been criticized by the housing industry. FHA now lacks the depth of staff, it is asserted, to underwrite loans on its own, and lengthy delays and backlogs in processing are predicted.

HOW MUCH SUBSIDY IS ENOUGH?

One of the most obvious derelictions of HUD administrators, in hindsight, was the failure to hold subsidies to the amounts necessary to get the desired results. This is illustrated by HUD practices in connection with the Section 8 Moderate Rehabilitation Program. HUD officials did not take into account the value of low-income tax credits available to developers; and they failed to recognized that the Section 8 payments given to Moderate Rehabilitation projects were set at levels that bailed out excessive valuations placed on the properties by private coinsurers.

The low-income tax credit was authorized in 1986, and some Moderate Rehabilitation developers simply took the new benefit and in some cases sold it to high-income investors. HUD staff failed to take the value of the new tax subsidy into account in approving subsidy levels under its own program.

As for overly generous allowances under the Section 8 Moderate Rehabilitation program, HUD's Inspector General found that certain mortgage companies regularly overvalued the properties they coinsured by using higher priced buildings for comparables, certifying excessive rehabilitation costs, underestimating operating expenses (hence overstating net income to be capitalized), and similar practices. Thus, despite the requirement that for-profit entities have a 10 percent to 15 percent equity or down payment in the project, some FHA borrowers were able to "mortgage out"--that is, to secure a mortgage larger than the actual cost of acquisition and fix-up of the Moderate Rehabilitation buildings. Such developers could walk away from the settlement table with an immediate cash windfall. There was apparently no institutional memory at HUD of the mortgaging out phenomenon that scandalized the Section 608 multifamily loan program of the early post-World War II period.

SYSTEMIC WEAKNESSES IN PROGRAMS

Such weaknesses may be attributable to initial design at the legislative stage or to changing circumstances unanticipated by policy makers. Secretary Kemp has blamed many of HUD's failings prior to his arrival as systemic in nature, including the aforementioned multifamily coinsurance program.

Another example is FHA's inadequate premiums for insuring high-risk, low down payment home loans. Income to the FHA funds has been insufficient in recent years to offset losses due to high default rates. (This is a problem that pending legislation aims to correct.) In a rapidly inflating real estate market, rising prices can often offset losses on delinquent mortgages; when prices are relatively flat or even declining (as is the situation today in some areas), the FHA insurance funds can take a big hit. Government insurance programs are flawed if they are substantially vulnerable to slowdowns or declines in market prices in the range experienced in recent years.

A major systemic difficulty in some subsidized housing programs is the expiration of the agreements with private owners or landlords, even though the number of families in need has not declined. In some cases, projects could be withdrawn from low-income use by prepayment of mortgages or eventual payment in full. Some proposals to deal with this problem would extend the agreements for an additional period of time, thus risking a repetition of the current dilemma. Similar uncertainties cloud the future of rent certificates or vouchers with a 5-year life.

To some observers, a potential systemic flaw in the making is the encouragement of homeownership among very low-income tenants of public housing, as provided under the Administration's HOPE plan. Many such families may simply lack sufficient stable income to maintain the properties in good condition without continuing operating subsidies. And the "investments" themselves may be poor ones because of their design or density or location near industrial plants, expressways, or other inharmonious uses. Are low-income families really being helped by Government inducements to buy apartments they cannot afford to keep up and which may not be worth much in the private market because of their undesirable locations? Proponents of HOPE are convinced, however, that homeownership for the poor under this plan is workable and will make a difference.

INABILITY TO ESTABLISH OR OBSERVE PERFORMANCE MEASURES

An indicator of HUD's overall performance is the extent to which the Department's programs are making inroads into housing needs of the groups who cannot afford market-priced homes. HUD's technical staffs prepare estimates of housing needs using such criteria as heavy cost burden (gross rent over 30 percent of income), physical inadequacies (such as breakdowns in plumbing or electrical equipment), and overcrowding. A recent technical report by HUD staff estimates the number of very low-income renters who are cost-burdened or living in inadequate or crowded units at 11 million households; another staff paper places the number of "worst case" renter households at 4 million. Whether the Administration and HUD's top leadership take such needs estimates into account in formulating policy and budget requests is not apparent. The Department's budget requests in recent years for incremental units of assisted housing have been for about 100,000 units or less.

In assessing the effectiveness of individual programs, one can ask: Are the intended beneficiaries, for example, very low-income people, the ones actually being served? The Department does not have current information on the incomes or other characteristics of families occupying public housing or Section 8 housing. Such information is now being collected, according to HUD staff, but meanwhile policy makers and analysts inside and outside the Department must rely on data about public housing tenants from 1979.

In determining program efficiency one seeks to know whether the desired results are being obtained at minimum cost. For example, are owners of assisted housing actually furnishing the level of services they have contracted to provide? HUD has too few field personnel to inspect all of the assisted buildings on a systematic basis. Are owners of assisted projects overstating operating expenses, making exorbitant claims for replacement outlays, or finding other ways to get an excessive subsidy? HUD cannot be sure since its auditors are only able to look at a sample of the assisted projects. For lack of current Census data on rents in individual market areas, it is not possible to know whether the fair market rents set by HUD staff are too high, providing excessive subsidy payments to owners, or too low, thus penalizing low-income voucher holders.

WHAT CAN A CONGRESSIONAL COMMITTEE DO ABOUT HUD'S MANAGEMENT?

A number of actions could be taken in the Congress to improve HUD's stewardship of housing programs. These include:

1. Clarifying HUD's missions. As discussed earlier, an agency is likely to give better direction to its staff and program participants, and can be held more accountable, if the purposes of the law are clearly specified. The problem is that policy makers in the Administration and the Congress may not see eye to eye and industry and consumer groups may have divergent interests. But enacting legislation that is all things to all men is a recipe for later discord on how the programs are being run.

2. Providing funds for the programs and agency staff commensurate with the problems being addressed. HUD became a hollow agency in the eighties, its funds to extend help to additional families trimmed, its personnel reduced and demoralized. The cutbacks probably contributed to abuses. With money eliminated for new construction or substantial rehabilitation under Section 8, developers turned to the Moderate Rehabilitation program to stay in the game. Fix-up costs under Moderate Rehabilitation were expected to be in the range of $3,000 to $10,000 per unit; in fact, they averaged $26,000 in a group of 41 projects examined by HUD's Inspector General, with some costing between $56,000 and $80,000 a unit.

3. Scrutinizing efforts to privatize governmental responsibilities. Giving mortgage lenders the entire underwriting function under the multifamily coinsurance program proved to be a case of "putting the fox in charge of the chicken coop." About proposals to privatize, questions to be asked include: Will it save the Government money? What are the incentives to do the job right? Is there profit in doing it wrong, badly, or out of spirit with the public policy intent? Does the private party have enough at stake to avoid taking undue risks for the public funds?

4. Providing enough subsidy to do the job--and no more. Administrators have a tendency to look only at their own programs. Thus, welfare program managers may not give much attention to the quality of housing occupied by welfare families, and housing officials may disregard benefits accruing to project investors via the tax code. Recently, legislators have begun to look for the interrelationships among subsidy programs and to seek ways of avoiding windfalls to investors. For example, the Department of Housing and Urban Development Reform Act of 1989 (Public Law 101-235) requires HUD to take account of proceeds available from any low-income housing tax credits in determining the amount of assistance to be made available to a Section 8 Moderate Rehabilitation project. The Department has not yet issued regulations to implement this change in law. Meanwhile, the Revenue Reconciliation Act of 1989 (Public Law

101-239) denies any credit for properties receiving assistance under the HUD Section 8 Moderate Rehabilitation program.

5. Anticipating systemic problems at the design stage. Congressional committees have a special opportunity to take note of systemic flaws in earlier housing programs. Looking back, one can say that programs that bank on inflation to bail out mistakes, such as FHA low down payment programs, will be especially at risk in the nineties because housing prices are not expected to rise much and may in fact decline in some areas. Programs that overemphasize starter homes or otherwise fail to allow for the coming of age of the baby bust generation could also prove costly to the taxpayers. The tendency to use the tax code rather than direct subsidies to induce investment in low-rent housing, arguably, is to choose to subsidize the wealthy to help the poor. The idea that "ownership" of a public housing project will transform families from welfare to the work force, from dependency to power, has been questioned. Critics recall the arguments used by the earliest advocates of public housing--it would rid the slums of juvenile delinquency, venereal disease, alcoholism, and other social ills; these proved to be quite simplistic. (See John P. Dean, The Myths of Housing Reform, in Urban Housing, edited by Wheaton, Milgram and Meyerson, pp. 255 ff.)

6. Regular monitoring of performance by congressional committees. Keeping an eye on HUD activities on a regular basis may help avoid some of the difficulties uncovered by investigating agencies in the past several years. The relevant committees may want to hire or add field investigators to their own staffs, and to hold hearings on a quarterly or semiannual basis without waiting for new scandals to break. What would one look for as indicators of worrisome trends or practices? The list might include:

-changes in the supply of assisted housing or number of assisted households;

-a rise in the number of projects whose owners take steps to prepay their mortgages and leave the assisted housing inventory; or owners or landlords who stop taking families with certificates or vouchers;

-increases in the number of HUD-subsidized projects placed on a watch list for financial difficulties;

-increases or decreases in vacancies and rent collection rates in public housing;

-changes in the numbers of applicants on waiting lists;

-results of efforts to encourage resident management and ownership of public housing;

-changes in the incomes of program beneficiaries that may require larger subsidies;

-rent increases in various areas that may result in higher fair market rents and higher subsidy payments;

-rising default rates on FHA-insured homes;

-rising inventories of assigned mortgages and HUD-owned property;

-changes in retained income or deficits for FHA operations;

-staffing patterns in HUD to determine whether all mandated programs are assigned appropriate and sufficient staff.

IN SUM

In the last analysis, effective management of Government programs requires political appointees who believe in the mission of their agency and bring relevant experience and integrity to their posts. Good administration is possible only when there is mutual respect between the political appointees and the career technical and administrative staffs. The following reflections, written two decades ago, still seem relevant:

> "To get an administrative unit to implement a policy or program, three conditions must obtain. First, the agency must identify with the goals of the policy. Second, there must be clear communication of what the top officials really want. Third, a penalty and reward system must be available to back up the official policy. Outside the administrative apparatus, the intended beneficiaries of a program must be convinced that real benefits will be forthcoming, and the community at large has to be persuaded that the policy or program is needed and is worth the cost." (Schussheim, Toward a New Housing Policy, Committee for Economic Development, 1969, p. 46.)